**PUBLIC VERSION**

**Before the**
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**Washington, D.C.**

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| **In the Matter of** | ) | |
| **ADJUSTMENT OF RATES AND TERMS FOR PREEXISTING SUBSCRIPTION SERVICES AND SATELLITE DIGITAL AUDIO RADIO SERVICES** | ) | **Docket No. 2006-1 CRB DSTRA** |

# REPLY TO SOUNDEXCHANGE'S PROPOSED FINDINGS OF FACT, JOINTLY SUBMITTED BY SIRIUS SATELLITE RADIO INC. AND XM SATELLITE RADIO INC.


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October 16, 2007

**PUBLIC VERSION**

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October 11, 2007

## I. INTRODUCTION AND SUMMARY

1. The parties' opening post-trial submissions underscore their dramatically different conceptions of what this proceeding entails, both legally and economically. Both parties recognize that this case is about the setting of a reasonable fee for the performance[1] of post-1971 sound recordings by the two preexisting satellite digital audio radio services under the standards prescribed by sections 114(f)(1)(A) and (B) of the Act. But the parties' interpretations of the requirements and underlying purposes of those statutory provisions diverge sharply.

2. The parties also agree that it is appropriate to examine benchmarks that, properly adjusted, are informative of the rate that should be established here. But their choices of benchmarks, and how they should be adjusted, are strikingly different. In short, the SDARS (i) chose the most appropriate benchmark; (ii) made essential adjustments to reflect the SDARS' unique combination of end-to-end functionality and non-music programming; (iii) identified a variety of other benchmarks that, when properly adjusted, corroborate the SDARS' rate proposal and establish a reasonable range of rates in the range of 1.2% to 4.2%, or $250 to $875 million in payments over the license period; and (iv) carefully weighed the policy interests in the governing statute and determined that a rate toward the low end of that range best satisfies those policy goals.

3. More specifically, the SDARS selected as their primary benchmark the fees agreed to be paid to the very same seller (SoundExchange) for the very same copyright rights (the section 106(6) sound recording performance right) by a category of similar-music-using entities – the preexisting subscription services (PSS) – that are subject to the same statutory

[1] As used in these Reply Proposed Findings of Fact, "performance" encompasses the "ephemeral" recordings necessary to facilitate those performances, licensed under section 112.

license standard (the four section 801(b)(1) policy guidelines) as are the SDARS. Rather, however, than simply apply the 7.25 percent-of-revenue fee payable by these benchmark PSS to the total revenue base of the SDARS, Dr. Woodbury recognized that an adjustment to the benchmark rate was necessary to account for the different range of services and functions provided to consumers by the PSS on the one hand and the SDARS on the other. The record establishes that the SDARS provide an end-to-end distribution infrastructure on a nationwide basis, the design, development and subsidization of end-user equipment, retail marketing, and customer service, whereas the PSS provide only a portion of such service – "handing off" their content to third-party cable television operators which, in turn, use existing infrastructure and devices to fulfill the remainder of the transmission and retail customer functions that, in the case of the SDARS, are integrated into their own end-to-end operations.

4. The significance of this distinction in the range of services provided by the SDARS (as compared to the benchmark PSS services) is critical for rate-setting purposes. The SDARS incur significant added costs in developing and providing this broader range of services, which costs are reflected in the retail fees they charge and revenues they earn for their services. A failure to account for these added costs before applying to the SDARS the percentage-of-revenue fee applicable to the benchmark services would result in a vast overpayment to SoundExchange of fees based on activities undertaken (and revenues earned) by the SDARS above and beyond those of the benchmark PSS. Dr. Woodbury's "functionality adjustment" accounts for precisely this disparity in services provided and – together with an equally important music/non-music adjustment to account for the fact that, unlike the PSS, the SDARS provide significant non-music programming – results in an adjustment to the PSS benchmark

that has the effect of consistently applying the applicable PSS royalty level to the functionally equivalent revenue streams of the SDARS.[2]

5. Other courts have endorsed just such an adjustment. In *United States of America v. Broadcast Music, Inc.*, 316 F.3d 189 (2d. Cir. 2003), for example, the Second Circuit explained that "[i]f it were demonstrated that retail purchasers were motivated to pay more because of advantages that resulted from a particular mode of delivery, such as better quality, better accessibility or whatever, this might justify a conclusion that retail price of the service purchased by the customer exceeded the fair market value of the music." *Id.* at 195. In other words, the Second Circuit approved exactly the type of adjustment made by Dr. Woodbury when he adjusted the PSS rate to account for the fact that the SDARS have developed a "particular mode of delivery" – namely, multi-billion dollar satellite-delivery systems – that result in "better quality," "better accessibility," and a panoply of other costly benefits. SDARS PFF ¶¶ 822-34. Even after this critical adjustment, the significant revenues and growing subscriber base of the SDARS ensures that their rate proposal would generate fees to SoundExchange during the license term of over a quarter of a billion dollars (even at the low end of the reasonable rate range) – a far cry from the "near zero" characterization suggested by SoundExchange in its papers. *See, e.g.*, SX PFF ¶¶ 2, 5.

6. For its part, SoundExchange selected benchmarks that meet few, if any, of its own experts' criteria for a good benchmark. None involve the same intellectual property rights as are involved here and none involves licensees subject to statutory licensing pursuant to the section

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[2] As described in the SDARS Proposed Findings of Fact, *see* ¶ 827, the result of the functionality and music/non-music adjustments can be expressed in either of two manners: by applying the identical 7.25% rate payable by the PSS to a functionally reduced SDARS revenue base or by reducing the effective percentage of revenue to be applied against the full revenues earned by the SDARS by the amount of the functionality adjustment. For the reasons already discussed, *id.* ¶ 828, Dr. Woodbury chose the latter approach.

801(b)(1) criteria. Indeed, two of SoundExchange's principal benchmarks do not involve musical content at all, and those that do were not adjusted to account for functionality differences (and related differences in cost structures) between the services involved and the SDARS. For SoundExchange, a royalty is a royalty: no matter how disparate from the SDARS the type of service, no matter how different the types of costs incurred or the nature of the services delivered, and no matter how distinct the copyright rights provided to consumers, whatever royalty rate was agreed to by these claimed benchmark services is (with limited exceptions discussed herein) proposed to be applied to the SDARS.

7. As for the legal framework governing this rate-setting proceeding, the SDARS have proceeded on the premises that:

- the copyright performance right at issue here is "a carefully crafted and narrow" one, designed by Congress to "address the concerns of record producers and performers regarding the effects that new digital technology and distribution systems might have on their core business," while at the same time not "hampering the arrival of new technologies" and the important consumer benefits they afford. SDARS PCL ¶¶ 27-28, 30 (quoting S. Rep. No. 104-128, at 13-15 (1995));

- part and parcel of that legislative effort to balance these twin interests is a statutory license mechanism which reins in the unfettered ability of the recording industry (four of whose members control 77% of the recorded music market, SX PFF ¶ 63) to condition access to their product on payment of whatever fee they demand;

- the statutory license, in the case of the SDARS, requires assessment of the four policy objectives set forth in section 801(b)(1) of the Act;

- section 801(b)(1)'s policy objectives – on their face and as confirmed by all precedent – are not designed simply to generate the very marketplace prices that the recording industry could attain in the absence of the statutory license;

- the section 801(b)(1) policy objectives instruct the Judges to determine a reasonable fee by taking into account not only a fair return to the recording industry but also the economic circumstances of new technologies such as the SDARS and the contributions made by the providers of those technologies;

- the resulting reasonable fees "shall be calculated to achieve," among other objectives, a "fair return" to the record companies and a "fair income" to the SDARS "under existing economic conditions" and shall "minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices"; and

- in accordance with section 114(f)(1)(B), in determining a reasonable fee, a narrow class of agreements are deserving of specific consideration by the Judges, viz., sound recording performance agreements negotiated by services governed by the section 801(b)(1) standard.

8. SoundExchange seeks to negate the intent of the statute by distorting both the intended scope of the sound recording performance right and the governing legal framework. In doing so, SoundExchange improperly shifts the playing field, asserting in the very first paragraph of its proposed findings that this is "a case about the value of music to the SDARS," SX PFF ¶ 1, when it is instead a proceeding to determine a reasonable value for the limited right to play certain sound recordings – a much smaller element of the SDARS' programming than "music." Further, evidently finding that the section 801(b)(1) factors limit the recording industry's ability to extract very large sums from potential new sources of income (such as SDARS) to replace declining revenue from physical CD sales, SoundExchange adopts the premise that section 801(b)(1) has little if anything to do with congressionally mandated policy objectives and is instead an elaborate proxy for the price that would prevail in dealings between the SDARS and the recording industry in a market unregulated by Congress. SoundExchange does so with full knowledge that the "willing-buyer/willing-seller" standard it proposes in this case was not adopted by Congress in 1995, *see* SDARS PCL ¶¶ 27-34, and explicitly rejected in 1998, *see id.* ¶¶ 35-39 – and consistently has been found to be an impermissible interpretation of section 801(b)(1) by predecessor rate-setting bodies, by the Librarian of Congress, and by the courts. *See id.* ¶¶ 46-53.

9. To the extent SoundExchange purports to account for the 801(b)(1) policy objectives at all, it does so from a skewed perspective that presumes the dominant function of the Judges here to be to protect and preserve the recording industry, with scant concern for the consequences to the SDARS. Reading SoundExchange's submission, one would scarcely know that the interests of any entities other than the recording industry are implicated by the objectives either of the copyright laws in general or of the statutory license scheme here involved in particular. This approach to ratemaking contravenes the balancing Congress so clearly intended in the statute in order to facilitate the emergence of socially beneficial new digital means of disseminating creative works.

10. These sharply different views as to the fundamental objective of this rate-setting process infuse the parties' respective approaches to rate-setting as well as their resulting fee proposals. Sirius and XM believe the Copyright Act means what it says and that the best place to start is with the language of the Act. Section 114(f)(1)(B) identifies a narrow class of agreements for specific consideration by the Judges – sound recording performance agreements negotiated by services governed by the section 801(b)(1) standard. Those services include only the PSS and the preexisting SDARS. In developing their fee proposal, the SDARS start with the fee last negotiated by the PSS and, as noted, make essential adjustments for fundamental differences in services provided and functions performed between the SDARS. The PSS and the SDARS then demonstrate that the only other known agreement within the class of agreements identified by section 114(f)(1)(B) – their prior agreement with SoundExchange – supports a fee within the range identified by the SDARS.

11. The record also demonstrates that a fee within the range of rates the SDARS identify is essential to provide them with a chance to earn a fair income over time, to recognize

the massive contributions made by the SDARS in technology, investment, cost, risk, and creativity, and to avoid disruption to the industry and to prevailing industry practices. The record similarly demonstrates that a fee within the range of rates the SDARS identify will maximize the availability of creative works, allow a fair return to copyright owners and performers, and provide compensation for the contributions of the copyright owners to their services.

12. Indeed, the fees proposed by the SDARS, more than $250 million over the license term, dwarf the performance rights fees paid by any other industry to the record companies by a factor of six. *See infra* Part II.A. The SDARS further demonstrate that the range of rates they identify is corroborated by numerous benchmarks and data points, including the fees paid by the SDARS for the complementary musical works performance right and a number of the benchmarks advanced by SoundExchange, once SoundExchange's major distortions and errors are corrected – including the costs to the SDARS of non-music programming and the more analogous record company deals with other services, adjusted for fundamental differences in the services provided and cost structures between those services and the SDARS.

13. SoundExchange, by contrast, redefines the applicable standard to its liking and advances a number of contradictory positions in an effort to support its exorbitant fee proposal – a three-to four-fold increase in fee rates at the outset to a more than eight times rate increase by 2012. Since these escalating rates are applied each year to substantially increasing SDARS revenues, the overall effect of their adoption will be even more devastating to the SDARS' finances: $40 million in SDARS performance rights royalties in 2006 (2.5% of the SDARS' combined $1.57 billion in revenue) becomes $160 million in 2007 and $836 million by 2012,

with a cumulative total of more than $2 billion over the license period, according to SoundExchange expert Mr. Butson's projections.

14. Notwithstanding that the SDARS were grandfathered under the provisions of section 801(b)(1) (rather than subjected to the DMCA's newly-crafted "willing-buyer/willing-seller standard") in order to prevent disruption to them and to foster the continued development of their services (*see* SDARS PFF ¶ 39), SoundExchange turns this congressional objective on its ear by devoting many pages to a recitation of the current challenges faced by the recording industry (which nonetheless continues to thrive financially, *see id.* ¶¶ 229-231) and concludes with the remarkable proclamation that "[i]f any party needs a rate that amounts to a hand-out, it is [the recording industry,] not the SDARS." SX PFF ¶ 49.

15. In a further effort to turn section 801(b)(1) into a provision designed to afford the recording industry government-sponsored profit relief, SoundExchange characterizes the SDARS, which have accumulated more than $7 billion in losses and have yet to turn a profit, as an "incredible success" (*see* SX PFF ¶ 203); as benefiting from "significant barriers to entry for additional competitors" (*see id.* ¶ 235); and as "a key part of the record industry's future as an important digital revenue source " *See id.* ¶ 154.

16. At the same time, to forestall the Judges from concluding that the SDARS fulfill the availability and "opening new markets" objectives of section 801(b)(1), SoundExchange – in contradictory fashion – portrays the SDARS as merely one of a "broad array of other services that compete in a vast audio entertainment market" (*id.* ¶ 72); as affording but one of "many different channels through which sound recordings are distributed" (*id.* ¶ 808); and, "rather than opening new markets," as "merely displacing music consumption in other markets." *Id.* ¶ 1015. In furtherance of these positions, SoundExchange beats a hasty retreat from its assertion as to the

centrality of the SDARS to the recording industry's future. It instead observes that "with or without satellite radio, sound recordings will be available to consumers on more platforms and in more ways than ever before." *Id.* ¶ 810; that "even if [the SDARS] did cease offering sound recordings" as a result of paying at the fee levels proposed by the recording industry, there would be little discernible impact on the distribution of sound recordings, insofar as the SDARS "are only one of many services that disseminate wide numbers of sound recordings to the public." *Id.* ¶ 806.

17. Notwithstanding section 801(b)(1)'s objectives to foster not only a fair return to copyright owners, but also a fair income to the SDARS, as well as to minimize disruption to the SDARS' still-fragile businesses, SoundExchange proclaims that "[t]he determination of content value should not depend upon the start-up or operational costs of a particular distribution service." *Id.* ¶ 831. The SDARS should pay (SoundExchange's conception of) full-market rates, and not a penny less. *Id.* ¶ 828. ("[T]he record companies should not be forced to subsidize the SDARS through discounted royalties...."). If the SDARS cannot survive as a consequence of their failure to be able to sustain the "relatively higher royalty rate" sought by the recording industry (*Id.* ¶ 810), according to Sound Exchange the consuming public will be no worse off. *Id.* "The real issue," by SoundExchange's reasoning, "is whether new sound recordings will continue to be created." *Id.*

18. Not surprisingly, these disparate conceptions of the task before the Judges have translated into dramatically different fee proposals. To the SDARS, the record establishes that, to satisfy the statutory objectives defining a reasonable fee, the fee must fall within the range between 1.2% and 4.2% of their total revenues (based on current usage of copyrighted sound recordings) and that the evidence points to a fee at the low end of that range. Such a fee would

more than reasonably compensate (*i.e.*, provide a fair return to) the recording industry for performances of sound recordings by generating between $250 and $875 million over the license term.

19. The SDARS further believe that a reasonable fee is one that varies with their usage of copyrighted sound recordings and one that enables them to obtain the necessary rights through direct dealing with copyright owners, without having to pay twice for those rights.

20. To SoundExchange, by contrast, a reasonable fee is many multiples of the range proposed by the SDARS, starting with an immediate three- to four-fold leap to 8% of revenues and increasing to as high as 23% of revenues. In dollar terms, the SoundExchange proposal would take more than two billion dollars from the SDARS during the license term, a period in which, absent the impact of SoundExchange's proposal, these entities hope to turn the corner financially and begin to realize positive cash flow and their first net income.

21. SoundExchange's fee proposal, with subscriber-based royalty increases that apply not only to incremental subscribers, but to all SDARS subscribers, effectively captures for itself 100% of the incremental revenues to the services from the addition of subscribers from approximately 15 million to approximately 22 million. *See infra* Part VI.A.5 (describing how the higher royalty fee applied to subscribers number 1 to 15 million would outweigh the additional revenue earned by the SDARS for subscribers number 15 to 22 million). Such a rate structure would deprive the SDARS of the benefits from developing innovative programming, improving their technology, or otherwise attracting subscribers and thus remove the incentive to undertake such initiatives. This approach – applying sharply increasing rates to all subscriber revenue – in itself would cripple the business potential of the SDARS and cause severe disruption to the industry structure.

22. SoundExchange's Shapley value model would award 62% of the alleged (and non-existent) "surplus" generated by the services to the recording industry, and only about 10% to the SDARS, despite the fact that the SDARS took all of the risk, made all of the investment, and incurred all of the costs in bringing their end-to-end systems to the public, and the recording industry took none. Further, SoundExchange economist Dr. Pelcovits' model would not provide any other return on the enormous investments that the SDARS have made in their businesses.

23. Even if the SDARS could accurately predict the future and were successful in meeting projected revenue objectives more than a decade into the future, SoundExchange's fee proposal would result in the cumulative net loss of Sirius not returning to its December 31, 2006 level until 2018, after the end of the next statutory license term. XM's cumulative net loss would not return to its December 31, 2006 level until after 2020. *See, e.g.*, SDARS PFF ¶¶ 196-97. In other words, notwithstanding the tremendous economic uncertainty more than a decade in the future, and the fact that application of the section 801(b)(1) guidelines "shall be calculated to achieve" the prospect of a fair income to the SDARS "under existing economic conditions," as well as a minimization of disruption to their businesses, the added cost of SoundExchange's fee proposal (when loaded on the SDARS' existing business prospects) would prevent each of the services from earning any net income on a cumulative basis over a period of more than a decade.

24. Moreover, the fee SoundExchange proposes would be mandatory, regardless of whether a service reduces its usage of sound recordings or pays a copyright owner directly to obtain the necessary rights. As the record demonstrates, this inherently unsound economic approach should be rejected in favor of a "per play" rate, at least as an alternative to any fixed mandatory rate applied to total revenues or subscribers.

25. It is evident that none of the foregoing elements of SoundExchange's fee proposal promotes the objectives of section 801(b)(1). Rather than reward the SDARS' innovation, risk-taking, and enormous investment in their end-to-end systems, such a rate would expropriate the resulting revenues. Rather than provide a fair income to the SDARS, it would put them in a very negative long-term financial position. Rather than minimize disruption to the SDARS' businesses, it would jeopardize their viability and their ability to continue making a wide range of sound recordings broadly available to the public.

26. SoundExchange misconceives this case in other ways. Its opening statement that "this is a case about the value of music to the SDARS," SX PFF ¶ 1, is an error that infects SoundExchange's entire case. Above and beyond the lack of any statutory or legislative history support for the notion that "reasonable" statutory rates should be based solely on consumer value, SoundExchange's attempt to extract maximum consumer value for the alleged "value of music" suffers from other substantive and methodological flaws:

- As noted, SoundExchange does not license "music," it licenses certain sound recordings. The music contained in these sound recordings is separately licensed by ASCAP, BMI and SESAC and is separately paid for by the SDARS.
- By invoking "music," SoundExchange seeks to capture a great deal of value to which it is not entitled. Much of the music performed by the SDARS, and a great deal of the value in the SDARS music programming, is not licensed under this statutory license. For example, the license at issue does not apply to live performances; it does not apply to recordings fixed before 1972; and it does not apply to the elements added by the SDARS to their music programming, all of which have been directly shown to have substantial value. *See* SDARS PFF ¶¶ 854, 917-18.
- In any event, SoundExchange dramatically overstates the value of music to the SDARS, relying on a single question from the flawed Wind study which offered respondents an all-or-nothing choice, distorting the significance of the SDARS' internal surveys and failing to address the undisputed testimony of the SDARS' executives struggling to make their businesses financially successful.

27. In another sense, SoundExchange's repeated invocation of the value of "music" is instructive. It reflects an implicit acknowledgement by SoundExchange that "music" is more valuable than "sound recordings." It also confirms the SDARS' use of their payments for the real music – the musical works right – as a reasonable indication of an upper bound on the price to be paid for sound recordings.

28. SoundExchange's attempted resort to benchmarks reflecting the royalties that would be generated in a competitive market not only misapprehends the purpose of this proceeding, it fails in its very objective. Although SoundExchange pays lip service to competitive market principles, SoundExchange's concept of "value" is the value that could be extracted by a perfectly price discriminating monopoly. Thus, for example:

- The Wind study, on which SoundExchange relies, does not ask for the value of music programming at the margin, or even the value of any particular catalog of sound recordings; rather, it asks a single all music-or-no music question and seeks to contrast that with removal of sub-species of non-music programming. The many defects in the Wind study are discussed in Part IV.A, *infra*; *see also* SDARS PFF Part VII.A.

- Dr. Pelcovits defines his Shapley value model to require the SDARS to obtain 75% of sound recordings and then rigs his game so that it results in almost twice the payments to the record companies than they would get if Dr. Pelcovits had modeled a single-seller monopoly.

- SoundExchange attempts to measure alleged substitution by the SDARS for CD sales at the industry level, without taking account of the competitive forces between the record companies. The surveys on which SoundExchange relies are fatally defective for a host of reasons, but even the one survey that the Judges have not already rejected asks about substitution at the cartel level, not the competitive inter-company level.

29. SoundExchange makes much of the claim that its fee models all converge to SoundExchange's proposed range of fees. That, however, is the result of flaws in the models and numerical gamesmanship, not facts, economic principles, or logic, illustrated as follows:

- Professor Ordover's benchmarks all involve buyers that differ dramatically from the SDARS in their cost structure, the investments they have made, the risks they

have undertaken and continue to undertake, and their lack of non-music programming and lesser contributions to their music programming. *See* SDARS PFF Part VII.F. Professor Ordover did not even attempt to adjust for these differences. Had he done so, the result would be fees much closer to the range identified by the SDARS. As Dr. Herscovici admitted, "a marketplace transaction involving a user that is different from one of the satellite radio services would not take into account the creative contribution, the investment, the technological contribution or the costs of the satellite radio service or the factor of fair income to the satellite radio services." 8/30/07 Tr. 75:20-78:12 (Herscovici).

- Dr. Pelcovits' non-music programming model is based on a misapplied economic theory and sellers that differ dramatically from the record labels, particularly for contracts granting a degree of exclusivity, which limits the ability of the seller to earn licensing revenues from other sources and thus imposes high opportunity costs. The model also relied upon a year not even in the license term, selected to maximize the resulting fee. The model also failed to examine the true cost to the SDARS of their non-music programming by failing to take account of substantial offsetting benefits included within the nominal cost of those deals. If the non-music programming model has any validity, once the methodological errors are corrected, it supports a fee in the range proposed by the SDARS.

- Dr. Pelcovits' Stern model likewise is based on a benchmark involving a dramatically different seller, facing dramatically different opportunity costs, and on the same flawed economic theory as the non-music programming model. The Stern model also fails to recognize the extraordinary circumstances that caused Sirius to enter into the Stern deal, fails to account for the enormous value in additional rights conferred by that agreement that are not comparably provided by the sound recording performance right here at issue, and is based on erroneous inputs that greatly overstate the result, including, among other things, Professor Wind's study.

30. Numbers games pervade SoundExchange's models. If a model is shown not to reach SoundExchange's "sweet spot," it changes the model. Thus, for example:

- When Professor Ordover's "immediacy adjustment" was shown to have disappeared, SoundExchange's lawyers were quick to inform Professor Ordover of a further, "intensity," adjustment that almost precisely made up the difference.

- After declaring 2012 for numerous reasons to be the appropriate year for analysis in his Shapley/surplus model, Dr. Pelcovits selected 2006, a year not even in the license term, as the basis for his non-music programming analysis. Dr. Pelcovits never offered an explanation for this inconsistency, and SoundExchange offers none in its Proposed Findings of Fact.

- The Shapley model is by SoundExchange's own accounts a "game." As Professor Noll testified, Dr. Pelcovits' version of the game was "rigged to

maximize the value of sound recordings" and "biase[d]" "in favor of the record labels."

- Dr. Pelcovits decided to exclude Sirius' Stern contract costs from his non-music programming model. Had he included Stern, the resulting fee would have been so high as to demonstrate the lack of credibility in the model. After learning at trial that Dr. Pelcovits committed an $82.9 million error in his model, reducing its result below SoundExchange's point of "convergence," even for 2006, SoundExchange returned with a re-analysis including the Stern costs.

31. SoundExchange asserts that copyright owners must engage in "value based pricing," SX PFF ¶¶ 26, 1346, but it distorts that concept beyond the breaking point. The economists agree that the prices paid for copyrighted works should be based on long-term average costs of efficient production rather than marginal costs. *See, e.g.*, Noll WRT at 110-12. But SoundExchange makes no showing whatsoever that its proposed fees are necessary to enable the record companies to recover their long run average costs of efficient production. Rather, the record demonstrates that the record companies remain profitable and that digital sales are increasing exponentially – from many sources beyond the SDARS. *See infra* Part III.B.2.a. To SoundExchange, value-based pricing means extraction of as much consumer surplus as possible. That is not consistent with the competitive market paradigm proposed by SoundExchange or with the "reasonable" royalties required by section 801(b)(1).

* * *

32. Rate-setting is not an exact science, but rather, as the statute itself instructs, an effort to identify "reasonable" rates that balance competing issues of fairness, contribution, and disruption to the respective copyright owners and services. The SDARS have attempted to identify the most appropriate benchmark, to apply necessary adjustments, consistent with prior case law, that reflect the SDARS' unique end-to-end functionality, cost structure, and mix of music and non-music programming, and to take account of the statutory guidelines that drive this proceeding. The SDARS' rate proposal (or a rate within the range of reasonable rates identified

by the SDARS) will avoid significant disruption to the companies' operations or the need to fundamentally change the nature of their services – including changes that would sacrifice rather than maximize the availability of sound recordings to the public. It will provide the recording industry with a fair return – $250 million to as much as $875 million – for an additional stream of sound-recording revenue that costs the record companies nothing, while at the same time providing the SDARS with at least the possibility of earning a fair income in the future. Finally, it will recognize that it is not the duty of the SDARS to make up for declining CD sales and record-industry losses that the SDARS did not cause and that was well underway before the SDARS launched their services.

## II. THE SDARS' RATE PROPOSAL REMAINS THE MOST REASONABLE RATE PUT FORWARD IN THIS PROCEEDING.

### A. The SDARS' Rate Proposal Will Pay the Record Companies and Artists Over 250 Million Dollars over the License Term.

33. The SDARS' Proposed Findings of Fact described at length the SDARS' fee proposal – $1.60 per Play for 2007 with annual increases based on the percentage increase in combined SDARS subscriber growth – and the many reasons it should be adopted. *See* SDARS PFF Part VI.

34. SoundExchange and its witnesses attack the SDARS' proposal as an outlier with an untenably low rate, and mischaracterize is as a "near zero" proposal. *See* SX PFF ¶¶ 2, 5, 1312-18. Focusing solely on the percentage of revenue from which the SDARS' fee proposal derives, SoundExchange conveniently ignores he very significant revenue base to which that percentage rate was applied in converting the fee proposal into the proposed per-Play rate.

35. To make this more concrete, the SDARS' large revenues and growing subscriber base (which forms the basis for the proposed annual increases to the per-Play rate) ensure that the total payment to the record companies and artists during the license period will be very

substantial. The following table demonstrates just how substantial. (For comparison's sake, the table also includes payments that would be made at different points in the range of reasonable rates identified by the SDARS in their Proposed Findings of Fact. *See id.* ¶¶ 850-58.)

| | **Per-Play Rate**[3] | **Approximate 2007 SDARS Payment**[4] | **Total 2007-2012 SDARS Payment** |
|---|---|---|---|
| PSS Benchmark (SDARS Fee Proposal) (1.2% of revenue) | $1.60 per Play | $25.1 million | $251 million |
| Custom Radio Benchmark (2.57% of revenue)[5] | $3.43 per Play | $53.7 million | $537 million |
| Corrected SX Non-Music Programming Benchmark (3.51% of revenue)[6] | $4.69 per Play | $73.4 million | $733 million |
| "Disruption point" (4.2% of revenue)[7] | $5.61 per Play | $87.8 million | $877 million |

36. As should be obvious, neither the SDARS nor their experts propose that the royalty payments be "near zero" – but rather in the hundreds of millions of dollars. As shown

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[3] The calculation of the per-Play rate under the SDARS' fee proposal was described at SDARS PFF ¶¶ 845-47. Briefly, the SDARS' proposed per-Play rate is reached by multiplying the benchmark percentage rate times 2007 revenues of $2.091 billion and then dividing by the SDARS' total number of annual compensable plays of 15.66 million.

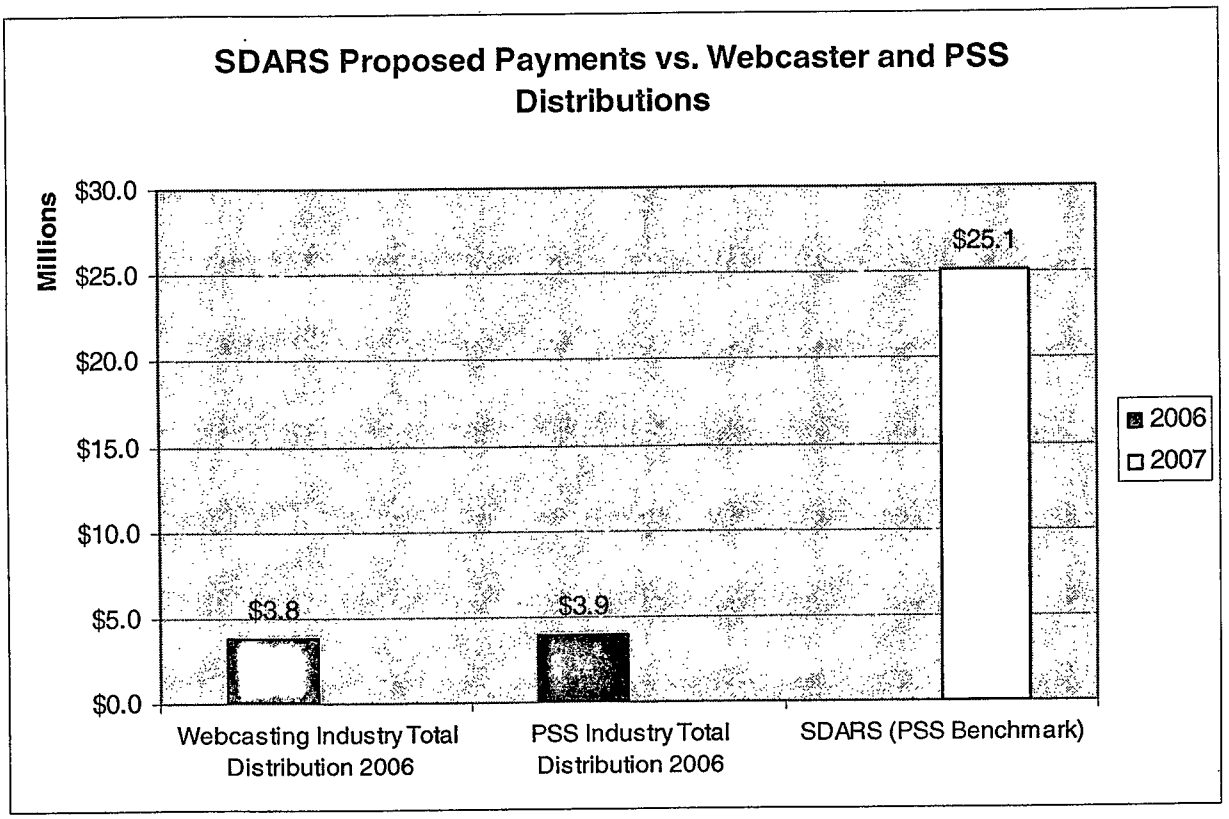
[4] Annual and 2007-2012 totals are calculated in a straightforward manner: according to the estimates provided by Mr. Frear and Mr. Vendetti, the SDARS' combined year-end subscribers will increase from 13.653 million in 2006 to 17.276 million in 2007, 20.996 million in 2008, 24.469 million in 2009, 28.157 million in 2010, 31.822 million in 2011, and 34.666 million in 2012. Frear WRT Ex. 58 (Sirius Trial Ex. 61); Vendetti WRT Ex. 4 (XM Trial Ex. 10). Under the SDARS' fee proposal, the per-Play rate would rise from $1.60/Play in 2007 to $2.03, $2.46, $2.87, $3.30, and $3.73 in each succeeding year. Assuming the number of Plays on the SDARS remains fairly constant, the total royalties would rise from approximately $25 million in 2007 to $58.5 million in 2012, or $251 million total. The same basic arithmetic is used to calculate the total dollars generated by the other per-Play rates listed in the table.

[5] SDARS PFF ¶ 855.

[6] *Id.* ¶ 856.

[7] *Id.* ¶ 857.

below, the payments detailed above in fact outstrip by many multiples other sources of annual statutory license income received by the record companies:[8]



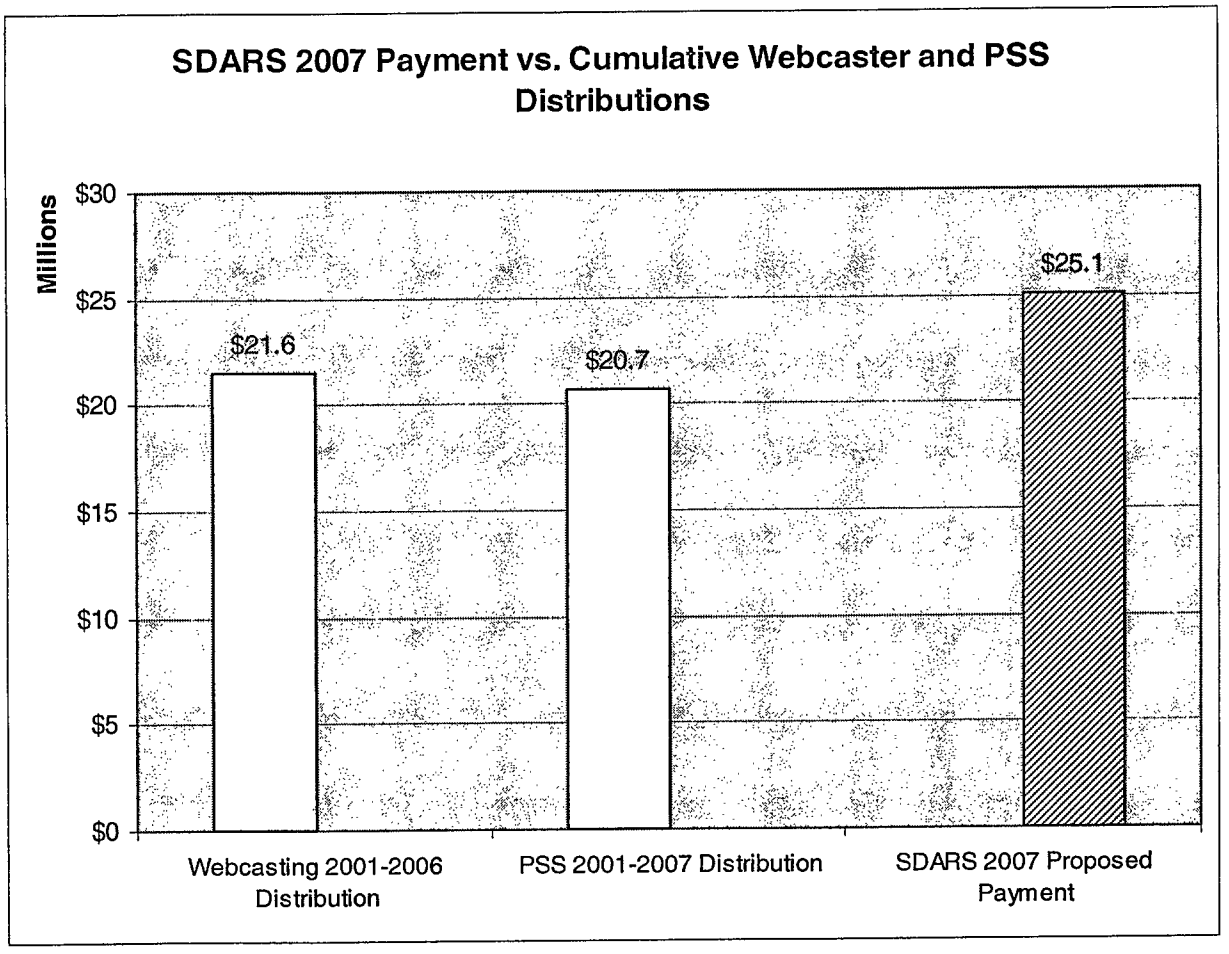

37. As the foregoing demonstrates, in the first year of the license period alone, under their proposed PSS benchmark the two SDARS will pay an estimated total royalty payment of $25.1 million or:

- six times the total SoundExchange distribution of webcasting royalties from the entire webcasting industry in 2006 (this despite the fact that the webcasting rate is set under the willing buyer/willing seller standard); and
- six times the total SoundExchange distribution of PSS royalties in 2006 – demonstrating that while the SDARS rate may be based on the percentage of

[8] The webcasting and PSS payments are taken from SDARS Trial Ex. 25, which provides data on SoundExchange royalty distributions by industry/type of service, as opposed to collections – *i.e.*, payments by the service to SoundExchange (the data for which were not available). As a result, the figures are presumably net of deductions for SoundExchange administration and costs. Unless SoundExchange is operating inefficiently, the collections (as opposed to the final distributions) should not be significantly higher than the numbers listed in the table, and in any case do not materially affect the comparison.

revenue paid by the PSS, it results in royalty payment that dwarfs the PSS payments.

38. In fact, the SDARS' payment in the first year of the license period would be more than the cumulative distributions from SoundExchange from the entire webcasting industry or preexisting subscription services since 2001:[9]




[9] *See* SDARS Trial Ex. 25 (SoundExchange cumulative royalty distributions). SoundExchange's report does not list any 2007 distributions for Webcasting.

## B. SoundExchange's Criticisms of the SDARS' Fee Proposal Are Unfounded.

### 1. The PSS Benchmark Service Is the Benchmark Most Comparable to the SDARS.

39. SoundExchange expends a great deal of energy in its proposed findings attacking the SDARS' PSS benchmark on the ground that, among other things, two PSS left the market subsequent to the 2003 negotiated agreement; XM and Sirius charge little for a similar service that they use to promote their primary service; and Music Choice failed in an attempt to market an "à la carte" music service several years ago. SX PFF ¶¶ 1296-1311. The SDARS addressed and responded to the majority of these criticisms in their Proposed Findings of Fact and will not repeat them here. SDARS PFF ¶¶ 869-73. A few points, however, warrant emphasis.

40. First, as SoundExchange experts agreed, what happened in the PSS industry after 2003, such as the exit of certain of the services or the alleged shift of Music Choice to a business of video-on-demand, SX PFF ¶ 1307, is irrelevant. *See* 8/27/07 Tr. 128:3-131:6 (Ordover). What matters is the state of the PSS industry at the time the agreement that serves as Dr. Woodbury's benchmark was signed and the evidence – from the RIAA's own mouth, no less – indicates that the recording industry negotiated that agreement fully and vigorously because it believed Music Choice was very successful. *See* SDARS PFF ¶ 871 (describing the RIAA's stated view, in a negotiation letter to Music Choice, that Music Choice was "flourishing").[10]

41. Second, contrary to SoundExchange's misleading assertions, *see* SX PFF ¶¶ 1319-20, Professor Noll did not "concede" or "acknowledge" the lack of value or reliability of Dr. Woodbury's PSS benchmark. Professor Noll did acknowledge that the PSS have "different

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[10] That being said, SoundExchange's allegation that Music Choice has "re-oriented" its business to video, SX PFF ¶ 1307, is a blatant misrepresentation of the testimony of Dr. Chipty, who simply testified that Music Choice is now "selling" more video-on-demand, not that such a business existed in 2003 or that such sales have in any way altered Music Choice's core audio business. SX Tr. Ex. 119 at SX Exhibit 209 RP, Tr. 200:21-201:2 (Chipty).

costs" than the SDARS, but he made that point in the context of arguing that Dr Woodbury was the only economist in the case who properly adjusted his benchmark rate to account for those cost differences between the benchmark services and the SDARS. *See* 8/16/07 Tr. 240:7-12 (Noll); *id.* at 236:19-237:2 ("[I]t has more similarities to this case than the others, and so I would find it more reliable as a way to use market determined rates affected by 801(b), than the other examples that have been put forth by other experts."); SDARS PFF ¶¶ 835, 1269.

42. Finally, the fact that Music Choice failed in its attempt to offer an à la carte music service tells us nothing about its value as a benchmark. As Dr. Woodbury explained, all this tells us is that consumers would not pay a separate fee for noninteractive radio without the mobility "injected" by the SDARS – an observation that supports his functionality adjustment. *Id.* ¶ 872; Woodbury WRT ¶ 21. What is more, the SDARS are not à la carte music services either; as much testimony has shown, their success and continued viability required that they bundle their music offerings with a variety of non-music content not available elsewhere. Even with mobility added, few consumers will pay for a music-only service with music they can get for free on terrestrial radio. *See, e.g.*, SDARS PFF ¶¶ 63-95 (describing Sirius' need to add non-music programming to music offerings to grow its subscriber base and survive).

43. In the end, as summarized in the following chart, the PSS benchmark remains the best benchmark on all relevant dimensions: the same sellers (the record companies); the same copyright right and work (public performance of sound recordings); the same type of service (radio-like noninteractive music channels); the same guiding rate standard (801(b)(1)); and a proper adjustment for the different costs and functionality of the benchmark service:

## Benchmark Comparison to SDARS

| Proposed Benchmark | Same Buyers (SDARS) | Same Sellers (Record Cos.) | Same Copyright Right & Work (Sound Recording Performance Only) | Includes Radio-like Music Channels | Same Rate Std. 801(b)(1) | Accounts for Cost/ Functionality Differences from Target |
|---|---|---|---|---|---|---|
| Music Choice | | ✓ | ✓ | ✓ | ✓ | ✓ |
| Musical works | ✓ | | | ✓ | | ✓ |
| Interactive music services | | ✓ | | | | |
| Interactive video | | ✓ | | | | |
| Noninteractive video | | ✓ | | | | |
| DBS content | | | | | | ? |
| Howard Stern | ✓ | | | | | ✓ |
| Non-Music Programming | ✓ | | | | | ✓ |

*See* SDARS PFF Appendix B.

### 2. SoundExchange's Criticisms of the 2003 Negotiated PSS Agreement Apply with Greater Force to Its Own Benchmarks.

44. SoundExchange argues that because we do not know exactly how the PSS and the RIAA weighed the specific 801(b)(1) factors in reaching agreement in 2003, the resulting rate is a "black box" that cannot be a valid benchmark for this proceeding. *See* SX PFF ¶ 1263. In a classic case of trying to have its cake and eat it too, SoundExchange suggests that the rate is not an "801(b) rate" because it was not decided by an actual CARP proceeding, but that it is also not a market rate (despite being voluntarily negotiated) because it was negotiated in the shadow of a CARP proceeding. SX PFF ¶¶ 1267-70, 1277 *et seq.*

45. As the SDARS pointed out in their initial Proposed Findings of Fact, SoundExchange's own witnesses admitted, under questioning from the Judges, that the PSS rate does in fact reflect the parties' consideration of how the CARP would have conducted the 801(b)(1) analysis – and in that sense is an "801(b) rate." *See* SDARS PFF ¶ 819; 8/23/07 Tr. 280:21-282:4, 284:17-285:3, 285:10-288:1 (Ordover); 8/28/07 Tr. 130:3-14, 132:5-14 (Pelcovits). Unable to walk away from such admissions, SoundExchange now argues that even if the rate did reflect the 801(b)(1) factors, it would be useless here because those factors are time- and industry-specific.[11]

46. In so arguing, SoundExchange overlooks the fact that the same criticism can be leveled at its benchmarks (and indeed its fundamental approach to this proceeding) as well. Recognizing that the 801(b)(1) rate standard guiding the case – as well as the invitation of section 114(f)(1)(B) to consider previous agreements negotiated by the SDARS and PSS – compromises all of their marketplace benchmarks, SoundExchange has argued since the beginning of the proceeding that negotiated marketplace rates necessarily incorporate consideration of the 801(b)(1) factors and therefore do not require additional adjustment when applied to the SDARS. *See, e.g.*, Ordover WDT at 19-34. It is obvious, however, that to the extent those "free market" benchmarks achieve the policy goals of maximizing availability, fairness, creative and technical contribution, costs and risks, etc. (in itself a highly questionable assertion that SoundExchange has never proved or even adequately explained) it would be as those criteria apply to the benchmark services themselves, not as they apply to the SDARS, as

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[11] Covering every base, SoundExchange also argues that the rate would be a poor benchmark even if it were a "purely market-driven agreement." *See* SX PFF ¶ 1273. In light of SoundExchange's talismanic reliance on marketplace agreements, it is not clear why – and no explanation is offered.

SoundExchange's own expert Dr. Herscovici conceded. *See* 8/30/07 Tr. 77:1-78:12 (Herscovici); SDARS PFF ¶ 877.

47. In other words, one would need to adjust SoundExchange's time- and industry-specific benchmarks to account for the 801(b)(1) factors as applied to the SDARS in the same way that one would need to do so for the PSS. SoundExchange's benchmarks are every bit the "black boxes" that it accuses the PSS agreement of being.[12]

48. Moreover, Dr. Woodbury compared the SDARS to the PSS benchmark services on each of the 801(b)(1) factors and confirmed that the SDARS outperform the PSS on the 801(b)(1) factors, such that any if any adjustment to the PSS rate were warranted to account for those factors, it would be downward. *See* SDARS PFF Part VI.H. SoundExchange, by contrast, did nothing of the sort for any of its marketplace benchmarks. It simply offers a variety of market rates negotiated by unrelated services (many of them not even music services) for different or additional rights with the assurance that somehow the 801(b)(1) policy guidelines magically will be accounted for. In the end, SoundExchange's "black box" criticism compromises its own benchmarks more than those employed by Dr. Woodbury.

### 3. There Is No Evidence that the Record Labels' Partial Ownership of Music Choice Affected the 2003 Negotiation.

49. SoundExchange suggests that the fact that certain labels hold partial ownership of Music Choice would have affected the 2003 negotiation – implying that the record companies would have undercharged Music Choice to help it succeed. SX PFF ¶ 1274. SoundExchange

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[12] The suggestion that the PSS agreement is somehow different because one would need first to "remove" the effect of the 801(b)(1) factors as applied to the PSS and then "reapply" them to the SDARS, *see* SX PFF ¶ 1279, is pure sophistry; if market rates incorporate the 801(b)(1) factors with respect to the benchmark service, the effect of those factors likewise would need to "removed" before reapplication to the SDARS. SoundExchange cannot suggest at one moment that marketplace rates incorporate the 801(b)(1) factors, then claim in the next breath that they are free of the supposed taint of those factors.

also claims in support of this notion that Dr. Woodbury agreed that Music Choice's record-label owners would have an interest in "bolstering" Music Choice financially.

50. There are two problems with this argument. First, as Dr. Woodbury pointed out in his written direct testimony, Music Choice has other owners besides those record companies who would have ensured that the agreement remained "arms-length" and that Music Choice would not be pressured into accepting an inflated rate. Woodbury AWDT at 12 n.23. Moreover, Music Choice was not the only party to the PSS agreement; Muzak and DMX (who had no record label ownership) participated as well, and they likewise would have ensured an arm's-length bargain. On the other side of the table, the RIAA obviously represented many other record companies besides those three that had an ownership stake in Music Choice. Only if the RIAA had abdicated its responsibility to fully and loyally represent all of its members would it have offered Music Choice an artificially low rate that would benefit only three of them (the part-owners of Music Choice) at the expense of the others.[13]

51. Second, Dr. Woodbury's alleged "acknowledgement" of the record companies' interest in helping Music Choice came in the context of discussing their provision of promotional CDs to Music Choice, not in relation to the 2003 agreement. Dr. Woodbury simply pointed out that the free CDs represented the labels' efforts to get *airplay* on Music Choice in order to increase record sales – not an effort to support Music Choice financially. *See* 8/23/07 Tr. 100:1-105:4 (Woodbury).

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[13] In their Proposed Findings, the SDARS also discussed SoundExchange's failure to present any evidence in support of their claim, *see* SX PFF ¶¶ 1275-76, that the PSS rate was artificially low due to litigation costs, and the likelihood that such concerns would have led, if anything, to the PSS to accepting a higher rate. SDARS PFF ¶ 878.

### 4. The PSS Rate Is Not a "Musical Works Rate"

52. SoundExchange also argues that the use of the 2003 voluntarily negotiated PSS rate would "resurrect" a music works benchmark which has been "rejected" in the first webcasting proceeding. *See* SX PFF ¶¶ 1291-95. To the contrary, the 2003 negotiation, far from being "infected" by the musical works benchmark, if anything sanitized it. To start, the agreement represented a voluntary negotiation between the RIAA and the PSS over the rate to be paid for sound recording performances under section 114. There is no reason – and SoundExchange has presented no evidence of any reason – to think that the parties agreed to the 7.25% rate because they believed that sound recordings should be compensated on a comparable basis to what the PSS paid for musical works (which after all was simply evidence used by the CARP five years before to set the rate in 1998).[14] Indeed, by SoundExchange's own admission, it is not entirely clear what exact factors the parties took into account during the negotiation. As the SDARS pointed out in their Proposed Findings of Fact, if such evidence did exist, surely SoundExchange would have had access to it and could have presented it in this case. *See* SDARS PFF ¶ 878.

53. Moreover, when the parties reached agreement in 2003, *Webcasting I* had been decided. *See* Library of Congress, Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (July 8, 2002). If the RIAA truly believed that the 7.25% rate was a "musical works" rate, and that such a benchmark had been "rejected" by *Webcasting I* (as SoundExchange now suggests, SX PFF

[14] If SoundExchange did believe that, it would be, of course, evidence that sound recording performances under section 114 should be compensated the same as musical work performances.

¶ 1291), surely it could and would have demanded a higher rate in line with other marketplace benchmarks or gone to the CARP to vindicate its view. It did neither.

### C. SoundExchange's Attack on Dr. Woodbury's Adjustments Leaves Untouched the Conceptual Merit of His Functionality Adjustment and Relies on Irrelevant Marketplace Evidence.

54. In the process of attacking the 2003 PSS agreement (the starting point for Dr. Woodbury's analysis), SoundExchange makes several other related criticisms:

- the relatively low per-subscriber fee paid by cable companies to Music Choice makes it inappropriate as a benchmark, SX PFF ¶¶ 1299-1303;
- Dr. Woodbury treats music as a "commodity" by claiming that the record labels should not be able to tax the SDARS for revenues earned as a result of the SDARS investments and costs in providing a mobile service, *id.* ¶¶ 1325-34; and
- Dr. Woodbury wrongly assumes that "music" has an "inherent value" and fails to adjust for the difference in "derived demand" between the PSS and the SDARS as measured by their different consumer prices, *id.* ¶¶ 1335-60.

55. In short, SoundExchange believes that the higher *retail price* paid by SDARS subscribers reflects a higher "derived demand" for the underlying sound recording performances. It refuses to admit the obvious fact that the difference in price paid actually reflects the higher costs of the SDARS to deliver an end-to-end nationwide mobile service and the non-music programming which the SDARS provide. Each of SoundExchange's criticisms amounts to the contention that the labels should reap where they have not sown and get a share of the revenues generated by the tremendous innovation and entrepreneurship of the SDARS – revenues reflected in the higher per-subscriber fees paid to the SDARS as opposed to Music Choice. *Id.* ¶¶ 1326-28, 1364. There are several responses to this misguided view.

56. First, as should be obvious, Dr. Woodbury does not rely on the [[ ]] fee paid to Music Choice by cable companies. His proposal is based on the 7.25%-of-revenue fee negotiated in the 2003 PSS agreement – a rate that obviously grows with the revenue base to

which it is applied. As pointed out above, when that revenue percentage is properly adjusted and applied to the total revenues of the SDARS, it results in a fee for 2007 alone that will be larger than the royalties by both the PSS and the webcasters in the aggregate since 2001. *See supra* Part II.A.

57. Second, the fact that the SDARS and Music Choice receive different per-subscriber payments, in raw dollar terms, does not indicate a difference in consumer demand for the underlying sound recording performances on the two services, but rather the different price that can be charged for a service delivering those noninteractive performances through a proprietary mobile delivery system packaged with a variety of non-music content as opposed to a separate cable distributor in a non-mobile environment. SoundExchange is wrong, in other words, to suggest that the derived demand for sound recording performances on the two services is dramatically different and must be adjusted for. Dr. Woodbury proceeds from the contrary observation that the (derived) demand elasticity for sound recording performances on the two services is likely to be equal. Woodbury WRT ¶ 66. As he explained in his written rebuttal testimony, this assumption is reasonable in light of the fact that both services offer similar noninteractive performances on genre-based, radio-like channels. *Id.*. As Dr. Woodbury also explained, this is an assumption shared by Professor Ordover as well, as explained in his written direct testimony: "One would expect *a priori* that the derived demand elasticities for satellite radio do not differ substantially from the analogous elasticities in other distribution channels for sound recordings." Ordover WDT at 19; *see also* Woodbury WRT ¶ 66 n.41.

58. In light of this shared assumption, "fundamental economic principles" (to use SoundExchange's term) dictate that the significant difference in the price for the two services reflects not differences in demand for the sound recordings offered by the services but

differences in the underlying cost of other inputs – *e.g.*, the billions in costs incurred by the SDARS for developing their direct-to-consumer satellite delivery systems (as opposed to the PSS, who hand off their service to cable companies for delivery to the consumer) and the value of the SDARS' non-music content. Woodbury WRT ¶ 66. Again, SoundExchange's own economists agree: In *Webcasting II*, Dr. Pelcovits made the same point: if you have two services with identical derived demand elasticities for music, the price paid for the use of the music will be the same, and the difference in the final price paid by the consumer for the two services will reflect only the difference in costs of providing the two services. *Id.* ¶ 66 n.42 (discussing Dr. Pelcovits' testimony in *Webcasting II*). And in this very proceeding, Professor Ordover embraced the same "Hicks factors" that describe the inverse relationship between final-product demand elasticity (demand for the overall SDARS service) and input price (for sound recordings). *Id.* at n.43 (discussing Professor Ordover's deposition testimony).

59. As Professor Noll also explained in his rebuttal testimony, if a market for a music services is competitive, variable prices will reflect cost differences in the services, not differences in demand. Noll WRT at 114-15. Because it is implausible that all services have the same costs other than content, it is implausible that price differences are due only to differences in demand intensities. *Id.* at 115. Consumers will of course adjust their purchasing based on price – that is, they will purchase a more expensive music product only if they value it enough to pay the price required to cover its higher costs – but relative value adjusts to changes in relative price (and underlying costs), rather than price adjusting to (or reflecting) relative value. *Id.*

**1. SoundExchange's "Inherent Value of Music Claim" Is Fallacious.**

60. All of this is not to suggest, as SoundExchange claims, that Dr. Woodbury is contending or relying on the assertion that music has an "inherent" or "commodity" value that

must remain constant or fixed across all distribution channels. The SDARS dismantled this misguided accusation in their Proposed Findings of Fact. *See* SDARS PFF ¶¶ 879-85. Dr. Woodbury acknowledged on repeated occasions that the record labels will be able to receive different (higher) royalties in situations where their costs as the result of a particular use are higher – most notably in the case of interactive services that effectively replace CD sales. Marketplace evidence shows exactly this phenomenon, but it does not reveal that record companies receive a similar premium for mobility – which is the key distinction between the SDARS' noninteractive sound recording performances and those offered on the PSS. *See id.* ¶ 895.

61. The quotes assembled by SoundExchange do not support SoundExchange's "inherent value of music" allegations against Dr. Woodbury. *See* SX PFF ¶ 1336. In each one, Dr. Woodbury merely argues, consistent with what has been said above, that the record companies should not be compensated more highly for mobile performances on the SDARS than for non-mobile performances on the PSS. In no case does he go so far as to suggest that "music has a single, inherent value" across all platforms or channels regardless of what right is being offered or the extent to which the service might substitute for CD sales. *Id.* ¶ 1344. In fact, Dr. Woodbury went out of his way to make this clear. SoundExchange selectively quotes a portion of Dr. Woodbury's June 13, 2007 testimony but omits the colloquy that followed:

> Q If music has sort of an inherent value, wouldn't it be appropriate to use the per-play rate from the Webcasting case to figure out what that value is?
>
> A I'm getting stuck on "inherent value." As I explained before, with respect to Music Choice, and XM and Sirius, the underlying characteristics of the music are the same. If we're talking about a downloading service, the underlying characteristics of the music being delivered by the label aren't the same.

6/13/07 Tr. 43:22-44:12 (Woodbury).

62. In sum, Dr. Woodbury merely argues that the higher price charged by the SDARS relative to Music Choice is a result of the SDARS' efforts and not some increased value of the record companies' sound recordings. Dr. Woodbury's functionality adjustment thus did exactly what SoundExchange accuses him of ignoring: it accounted for the difference in revenue paid to the SDARS and that paid to the PSS by adjusting the PSS rate to credit the SDARS – and, properly, not the record companies – for their investment and innovation. SoundExchange may not like the fact that under Dr. Woodbury's eminently logical approach, the record companies do not get a share of that revenue generated by innovations to which they did not contribute. *See* SX PFF ¶¶ 1326-27 (complaining that "none of the value added by the retailer (which in the case of the SDARS is substantial) is collected" by the record companies under Dr. Woodbury's model). But SoundExchange has failed – both theoretically and empirically – to demonstrate that the record companies deserve to or in fact do receive a similar premium for noninteractive performances delivered on a mobile basis rather than a non-mobile basis.

**2. Rates for Portable Interactive Downloads Are Irrelevant.**

63. Not surprisingly, SoundExchange spends a great deal of time in its Proposed Findings of Fact discussing the alleged premium that the record companies receive from portable interactive services that allow consumers to make copies of MP3 files on portable devices. SX PFF ¶¶ 1350-57. Thus, SoundExchange attempts to suggest that the SDARS are "portable" services as well and thus should pay a similar premium. *See id.* ¶ 1355. In the process, SoundExchange conflates the critical distinction between the concepts of "portability" and "mobility" and ignores the fact that SoundExchange's own witnesses repeatedly testified that the SDARS are mobile (that is, they deliver wirelessly directly to the receiver) and not portable (they do not allow copies to be made to a device that can be carried anywhere). *See* SDARS PFF ¶ 893 (summarizing SoundExchange witness testimony about the SDARS' mobility).

64. The SDARS' Proposed Findings of Fact predicted this line of argument and dissected its shortcomings at length. *See id.* ¶¶ 886-97. As shown there, SoundExchange has provided no evidence that services pay a royalty premium for noninteractive mobile performances of sound recordings. Given the absence of any such evidence, SoundExchange instead turns to a category of agreements – portable interactive subscription service agreements – that (i) Dr. Pelcovits himself rejected as evidence of a "mobility premium" in *Webcasting II*; and (ii) provide for a functionality (copies of MP3s on portable devices) that SoundExchange's witnesses admit is different than the mobility offered by the SDARS. *Id.*

65. SoundExchange attempts to present some additional evidence that the same portability premium charged for portable downloads on interactive services should apply to music streamed "on a mobile basis" (*i.e.*, that such a premium need not be limited to copies on a portable device as argued by the SDARS), but these arguments are without merit. First, SoundExchange argues that in a non-portable setting, interactive subscription services allegedly do not distinguish between on-demand streams and tethered downloads. SX PFF ¶ 1367. Of course this is beside the point: that on-demand streams and tethered downloads are functionally similar in the non-portable environment is irrelevant to whether the premium charged for making copies of MP3s to a portable device justifies a premium for noninteractive mobile streams on satellite radio.

66. SoundExchange nonetheless argues that the same principle holds in the portable world as well: "Dr. Pelcovits," SoundExchange writes, "does not believe that for the consumer, mobile streaming is any different from a functionality standpoint from portable conditional downloads." SX PFF ¶ 1368. But "believing" something to be the case is not the same as providing evidence that it is so, especially when a given functionality is not even offered in the

marketplace: as Dr. Pelcovits explained in *Webcasting II*, the portable services operate by allowing users to make copies to devices, not by mobile streaming directly to the device. *See* 8/28/07 Tr. 137:6-138:15, 143:8-17 (Pelcovits).

67. If Dr. Pelcovits is suggesting instead that the premium for portable conditional downloads should apply to noninteractive mobile streaming, his statement runs square up against his views as expressed in *Webcasting II*, where he refused to use the rate for "portable conditional downloads" as a benchmark for noninteractive "mobile streaming" precisely because he felt the two types of services were so different. *See* SDARS PFF ¶ 892.

68. SoundExchange further insists that "mobile streaming is very similar in value to portable conditional downloads" and cites Dr. Pelcovits' testimony where he claimed to have seen evidence – apparently a report by CRA filed with the FCC on behalf of the SDARS – that noninteractive music streamed to a cell phone is more valuable than music streamed to a computer. SX PFF ¶ 1368. Putting aside the fact that SoundExchange does not present any such analysis on its own – and references it only obliquely, through a quote of Dr. Pelcovits' hearing testimony – the CRA report shows no such thing.

69. First, the fact that certain cellular companies charge consumers a relatively high price for proprietary noninteractive streaming services on cell phones – most of which appear to package video, news, sports, and variety of other non-music programming with music – says nothing about whether such streaming is any way comparable to the value to consumers of interactive portable conditional downloads as SoundExchange suggests. *See* SX Tr. Ex. 106, Exhibit A at 22-25 (economic analysis of proposed merger by CRA International). Second, and more important, the CRA report merely reports consumer prices paid for those cellular streaming services; it does not indicate (and SoundExchange has presented no independent evidence) that

the record companies receive higher royalties for a service streamed to a cell phone than they receive for the same service streamed to a computer. *See id.* To the contrary, what is clear is that under *Webcasting II*, whatever prices cellular companies are charging consumers for noninteractive audio performances (the right at issue here) the royalty rate paid by the cellular carrier is exactly the same as it would be if those consumers streamed the same songs online to their computers. *Webcasting II*, 72 Fed. Reg. at 24,096. Further, for the same reasons discussed above, the final-product price charged to consumers (which no doubt includes a charge reflecting the costs of mobile delivery incurred by the cellular providers) does not imply that a higher royalty should or will be paid to the sound recording input provider.

70. In the end, the explanation for the portability premium paid by interactive services – the lone example SoundExchange has offered – is precisely the one Dr. Pelcovits has identified: it allows users to make copies to a portable device. As Dr. Woodbury explains, portability is uniquely valuable when combined with an interactive service that allows for listening to that copy at any time, and wherever the user chooses to listen – a condition that most closely approximates ownership of the song. 8/23/07 Tr. 187:22-189:2 (Woodbury).

71. SoundExchange's conclusion – "[i]n short, mobility commands a large premium in the marketplace, and generates higher royalties for the copyright holder," SX PFF ¶ 1369 – is utterly unjustified and devoid of evidentiary support. SoundExchange's tortured logic, inconsistent assertions, and fuzzy use of "mobile streaming" to conflate on-demand and noninteractive streams cannot overcome the complete lack of evidence that noninteractive mobile performances delivered directly to a device are more valuable than performances delivered to a computer.

72. SoundExchange is left with the unsupported assertion that the different retail price consumers pay to the SDARS – as opposed to the royalty rates paid by benchmark services to record labels – signifies that the underlying sound recording performances are more valuable to consumers on the SDARS than on the PSS, and that the record labels should be able to extract a portion of that value. For all the reasons discussed above, this view must be rejected.

### 3. Prevailing Case Law Supports Dr. Woodbury's Functionality and Non-Music Programming Adjustments.

73. SoundExchange quotes from the Second Circuit opinion in *United States v. Broadcast Music*, where the Court suggested that the fair market value of the music on a service is indicated by the retail fees paid by consumers, even where those fees implicitly include payments to cover the costs and processes of delivering the music to consumers.[15] SX PFF ¶ 1348 n.58.

74. Predictably, SoundExchange fails to quote the following language also found in the opinion:

> If it were demonstrated that retail purchasers were motivated to pay more because of advantages that resulted from a particular mode of delivery, such as better quality, better accessibility or whatever, this might justify a conclusion that retail price of the service purchased by the customer exceeded the fair market value of the music.

*Broad. Music*, 316 F.3d at 196 n.3. In other words, the Second Circuit endorsed exactly the type of adjustment made by Dr. Woodbury when he adjusted the PSS rate to account for the fact that the SDARS have in fact developed a "particular mode of delivery" – multi-billion dollar satellite-delivery systems – that result not only in "better quality" and "better accessibility," but a

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[15] The case, on appeal from the "rate court" in the Southern District of New York, involved the royalty rate that Music Choice would pay to BMI for the performance of musical compositions. The Second Circuit held that the rate court had improperly rejected a benchmark royalty rate from Music Choice's rival, DMX, because that benchmark was based on in part on DMX's retail revenues. *Broad. Music*, 316 F.3d at 195.

panoply of other costly benefits. See SDARS PFF Part VI.E.1. For reasons detailed by Dr. Woodbury, it would be dramatically unfair to apply a benchmark percentage-of-revenue royalty rate against the full retail price of the SDARS, given that the bulk of the revenues earned by the SDARS go to covering the costs of these many innovations and clearly "exceed" the value of the music alone. *Id.*

75. SoundExchange's selective quotations fail to account for the Second Circuit's imperative that if consumers pay "more" for a "particular mode of delivery" that offers significant advantages over the benchmark service – advantages reflected in the retail rate of the target service – that the retail rate may in fact overstate the value of the underlying music. While there was no reason in the *BMI* case to believe that consumers paid "more" for delivery-related aspects of Music Choice than they paid for the benchmark DMX service (which was distributed, like Music Choice, through cable television companies), there is every reason to believe that consumers do pay a significant premium to the SDARS, as compared to the benchmark PSS, for the end-to-end service and many benefits of the SDARS' delivery system. *See id.* Part VI.H.

76. The Second Circuit described yet another principle – again, omitted by SoundExchange in its recitation of the case – that the appeals court explained should guide the rate court in its determination:

> We recognize that where the customers pay a single fee for a package of audio and visual programming, which includes the music, it will be difficult to determine what part of the fees paid was for the music, as opposed to other programming.

*Broad. Music*, 316 F.3d at 195 n.2. Dr. Woodbury's non-music programming adjustment reflects this very principle as well – namely, that his benchmark PSS rate (taken from an all-music service) must be reduced before being applied to the gross revenues of the SDARS, since the "fee" paid by SDARS customers is paid for a "package" of programming that includes not

only music, but non-music programming as well. SDARS PFF at Part VI.E.2. As with the functionality adjustment, it would be dramatically unfair to apply a benchmark percent-of-revenue rate against the full retail revenue of the SDARS when much of that revenue is generated by "other programming." *Id.*

77. Notably, when the case returned to the Second Circuit two years later, of all the passages in its 2003 opinion, the court chose to quote the two reprinted above – those that support Dr. Woodbury's approach. *Broad. Music.*, 426 F.3d at 97.

### D. SoundExchange Misrepresents Dr. Woodbury's Exclusion of Pre-1972 Sound Recordings.

78. As described in the written rebuttal testimony of Dr. Woodbury and the SDARS Proposed Findings of Fact, Dr. Woodbury calculated his recommended per-Play rate first by calculating the SDARS' royalty payment as a percentage of SDARS revenue, then by dividing that payment by the number of compensable plays by the SDARS during the year. Woodbury WRT ¶ 53 and Exs. 29-30. "Compensable plays" included broadcasts of sound recordings dated after 1971, since recordings before that date do not enjoy federal copyright protection and thus do not require payment under the statutory license at issue in this proceeding.

79. SoundExchange suggests, in response, that because pre-1972 sound recordings have a lower value than post-1971 recordings, the SDARS do not deserve any sort of "discount" for their broadcasts of such recordings. SX PFF ¶¶ 433-34. SoundExchange also suggests that Ms. Kessler's analysis of Sirius and XM's past reports of use reveal flaws with Dr. Woodbury's methodology. *Id.* ¶ 436. Finally, SoundExchange suggests that XM and Sirius play so much post-71 music on their non-music channels that it somehow outweighs the pre-72 sound recordings played on their music channels. *Id.* ¶¶ 439-46. These criticisms betray a misunderstanding of Dr. Woodbury's methodology and are entirely without merit.

80. To be clear, Dr. Woodbury did not argue for a "discount" in the value of music on the SDARS because they play pre-1972 sound recordings. For example, he did not adjust the PSS benchmark rate by an additional 14% to account for pre-1972 recordings. Rather, he merely used the total annual number of post-72 recordings played on the SDARS in the final step of his rate calculation, when he converted his recommended percentage-of-revenue payment (1.2% of total revenues) into a commensurate per-Play fee. The 1.2% fee itself, from which Dr. Woodbury calculated the total payment, did not represent any "discount" for pre-72 recordings.

81. It is undisputed that the SDARS do not have to pay a royalty for a non-copyrighted sound recordings. The relative "value" of one recording versus another simply does not matter in the context of calculating the per-Play rate: a sound recording is copyrighted or it is not. SoundExchange's argument that post-1972 recordings might be listened to more, and thus have more value, is irrelevant in this context. *Id.* ¶ 434.

82. The other alleged problems identified by SoundExchange are equally irrelevant. Ms. Kessler's testimony as to problems with the SDARS' reports of use, *see* SX PFF ¶ 436, says nothing about the validity of Dr. Woodbury's analysis, which was not based on those reports. Obviously, if provided with the opportunity to pay on a "per-Play" metric, the SDARS will do everything necessary to identify the proper year of the sound recordings they broadcast to the extent that is an actual issue.

83. Moreover, the suggestion that the SDARS are "over-reporting performances [of] pre-1972 recordings, presumably in a belief that performance royalties to SoundExchange may not be due for such recordings," *id.* ¶ 436, borders on bad faith. SoundExchange knows all too well that the SDARS' payment obligation has not been based on how much music it plays or the year of the recording. SoundExchange also knows – at least one would hope it knows – that the

current reporting regulations do not require the year of a sound recording to be included in reports of use. *See* 37 C.F.R. § 370.3(c)(2)

84. Finally, the fact that there are feature performances of sound recordings on the SDARS non-music channels, *see* SX PFF ¶¶ 439-46, works to SoundExchange's favor. The SDARS will pay for those compensable performances, just like those on their music channels, at the recommended per-Play rate. Moreover, as previously discussed, to the extent the SDARS undercounted plays of post-72 recordings in the data they provided to Dr. Woodbury (such that the number of compensable performances he used as the denominator in his calculations was too low), that omission led to a higher recommended per-Play rate, a result decidedly in SoundExchange's favor.

### E. SoundExchange Misconstrues the Custom Radio Example Provided by Dr. Woodbury.

85. Finally, SoundExchange also argues that Dr. Woodbury's examination of the Yahoo!-Sony custom-radio agreement – where Dr. Woodbury applied his functionality and non-music programming adjustments to that agreement's rate of [[ ]] to reach a benchmark rate of 2.57% – is flawed. SX PFF ¶¶ 1370-75. The problem, according to SoundExchange, is that Dr. Woodbury failed to consider all the terms of the agreement, including the per-play rate. *Id.* ¶¶ 1372-73. Had Dr. Woodbury considered the per-play rate, SoundExchange contends, he would have realized that under the "greater of" formulation found in the agreement, the percent-of-revenue payment would be trumped by the per-play rate. *Id.*

86. It is SoundExchange's argument, however, not Dr. Woodbury's, that is "transparently flawed." SX PFF ¶ 1370. The Sony-Yahoo! custom radio agreement relied upon by Dr. Woodbury has no per-play rate. Woodbury WRT ¶ 68 n.44. Dr. Woodbury used Sony's agreement with Yahoo! for Yahoo!'s subscription custom radio service (since the SDARS

similarly operate by subscription), where Sony charges [[ ]]. During the hearing, SoundExchange attempted to impeach Dr. Woodbury by showing him Sony's contract for Yahoo!'s non-subscription webcasting service. 8/23/07 Tr. 182:1-3 (Woodbury) ("The contract we looked at, as I recall, was for a subscription non-interactive service."); *id.* at 183:17-184:5 ("I don't see anything here that suggests that this is a subscription service. . . . I'm doubtful that we relied on this contract."). In other words, Dr. Woodbury "conceded" only that an agreement other than that on which he relied on had a per-play rate option, not that the agreement he himself used did. SoundExchange's criticisms do not address the actual facts and are without merit.

### F. The SDARS' Musical Works Performance Royalties Corroborate the PSS Benchmark Despite SoundExchange's Attacks.

87. SoundExchange also attacks the SDARS' reliance on their musical works performance royalties as corroboration for Dr. Woodbury's PSS benchmark. *See* SX PFF Part VII.B. As discussed below, that attack is not only ironic in light of SoundExchange's own choice of benchmarks, but wrong on the merits.

88. As an initial matter, SoundExchange's criticism of the use of the SDARS' musical works performance royalties as a corroborative benchmark comes in the face of its own reliance on the SDARS' non-music programming agreements as benchmarks. *See id.* Part V.B. But musical works performance agreements involve the same buyers (the SDARS), the same right (public performance), similar sellers (music publishers versus record labels), and similar products (musical works versus sound recordings) as the statutory sound recording performance license at issue here. By contrast, the SDARS' non-music programming agreements involve:

- starkly different and additional rights (statutory sound recording performance right versus exclusivity, trademark and brand exploitation rights, and promotion and endorsement obligations, in addition to content rights);

- different sellers (record labels versus, *e.g.*, sports leagues and talk and entertainment celebrities); and
- different products (sound recordings versus a wide variety of complete packages of talk, entertainment, and sports programming).

Only the buyers are the same.

89. SoundExchange also argues against the musical works royalty as a benchmark because sound recording copyright owners have negotiated higher rates than musical works copyright holders for digital downloads, wireless full-length portable downloads, and mastertones and ringtones. *See id.* ¶¶ 1382-84. But SoundExchange's conclusion – *i.e.*, that the rate disparities allegedly demonstrate that "the sound recording is simply more valuable to the consumer, and therefore to the service" – does not follow. *Id.* ¶ 28. As even SoundExchange acknowledges, in every one of these contexts, the sound recording copyright owners negotiated those rates in the unfettered marketplace, whereas the musical works copyright owners were subject to a statutory license with the fee to be set pursuant to the section 801(b)(1) policy objectives. *Id.* ¶ 1384 n.61; *see* also 8/28/07 Tr. 282:20-284:21, 287:11-19 (Eisenberg). That, in and of itself, nullifies any value comparisons.

90. SoundExchange's reliance on alleged disparities in sound recording and musical works rates for pre-programmed and on-demand music videos and interactive streaming is similarly misplaced. SX PFF ¶¶ 1385, 1387. In each of these contexts, sound recording copyright owners negotiate such rates in the unconstrained marketplace, whereas the cited public performance rates for musical works are negotiated by ASCAP, which is subject to court supervision. *See* 8/28/07 Tr. 287:20-289:8 (Eisenberg). Moreover, the music video license rates that SoundExchange cites for sound recordings, SX PFF ¶ 1385, are for "all rights necessary to exploit," including reproduction and distribution rights. 8/28/07 Tr. 292:11-293:5 (Eisenberg). The musical works license rates, by contrast, are only for the public performance right. *Id.* at

287:20-288:7, 293:12-20. And as Mr. Eisenberg admitted, "the music publisher is not involved in creating the visual elements of the music video." *Id.* at 293:21-294:2.

91. As the SDARS discussed in their Proposed Conclusions of Law, the Librarian rejected precisely the comparison that SoundExchange attempts to make. *See* SDARS PCL Part V.C. In the section 801(b)(1)-governed PSS proceeding, the Librarian not only relied primarily on a musical works benchmark in setting the section 114(f)(1) sound recording performance royalty at issue there but also held that

> RIAA's contention that the data supports its assertion that the marketplace places a higher value on the contributions of the record companies and the recording artists in the creation of the phonorecord fails, because it does not discuss the constraining effect the mechanical license has on the copyright owners in setting a value on their reproduction and distribution right.

*Librarian PSS Determination*, 63 Fed. Reg. at 25,405. It reasoned:

> Because both groups do not share equal power to set rates in an unfettered marketplace, it is unreasonable to compare the value of the reproduction and distribution right of musical compositions – a rate set by the government at a level to achieve certain statutory goals – with the revenues flowing to record companies from a price set in the marketplace according to the laws of supply and demand, and then to declare that the marketplace values the sound recording more than the underlying musical composition. Consequently, RIAA's evidence sheds no light on the relative value of the sound recording performance right and the musical works performance right.

*Id.* SoundExchange's reliance on the same types of rate disparities resulting from a comparison of section 801(b)(1)-based musical works rates with sound recording rates set in an unconstrained marketplace, with record labels exercising substantial market power, directly contravenes the Librarian's determination and should be rejected.[16]

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[16] SoundExchange's citation of the Judges' recent webcasting decision does not alter this result. *See* SX PFF ¶ 1380. That proceeding involved different parties presenting different arguments on a different record under a different rate-setting standard.

92. SoundExchange surprisingly argues that "[e]ven the SDARS themselves pay very different rates for the musical works and the sound recording rights associated with the music they broadcast as part of their service." SX PFF ¶ 1390. But the SDARS have each been paying SoundExchange approximately 2.0% to 2.5% of their annual revenues for the past several years for the right to perform sound recordings on their satellite radio services. *See* 6/6/07 Tr. 16:5-8 (Vendetti); 6/12/07 Tr. 192:6-22 (Frear); SDARS PFF ¶¶ 813, 851. Similarly, the SDARS each pay ASCAP, BMI, and SESAC an amount totaling approximately 2.35% of their revenues for the musical works performance right. *See* Woodbury AWDT at 38; 6/12/07 Tr. 307:9-309:6 (Woodbury). Thus, the two rates are almost exactly the same.

93. SoundExchange's reliance on the allegedly different costs and risks shouldered by music publishers and record labels is equally misplaced. *See* SX PFF ¶ 1398. The relative amounts of money that the record and the music publishing industries spend is far less relevant to the question of the value of the two performance rights than is the relationship they share with respect to the SDARS. Because the sound recording embodies the musical work both copyrighted works go together. There would be no sound recording without a musical work, which is the very substance of the sound recording; the two are inseparably connected. Even Mr. Ciongoli testified, "I think it's a collaborative effort from the artist and the writer." 8/23/07 Tr. 238:16-18 (Ciongoli).

94. SoundExchange's insistence that "there is only one final product that is provided to the SDARS," SX PFF ¶ 1397 (emphasis added), and that "on the music publishing side, there is no creation of a final product," *id.* ¶ 1398 (emphasis added); *accord id.* ¶ 1401, is beside the point. The SDARS are buying a performance license, not a product. Thus, the fact that record labels face greater costs and risks associated with the manufacture and distribution of a physical

product – a CD – says nothing about the value of the performance license. *See* SDARS PFF ¶¶ 216-25.

95. Likewise, SoundExchange attempts to highlight the record companies' higher overhead and marketing expenses as evidence that the sound recording performance right is more valuable than the musical works performance right. SX PFF ¶¶ 1404-05. But there is nothing about "investing in music videos" or "promotional merchandise," *id.* ¶ 1404, for example, that contributes to the SDARS' ability to perform sound recordings over their satellite transmission systems.

96. At any rate, even if the inquiry into the value of the "final product" could tell something about the value of the performance license, the evidence SoundExchange has presented does not accurately depict that value. UMG's market share represents almost a third of the entire recording industry, while Universal Publishing represents only about 10% of the total market, and Mr. Ciongoli testified that he did not adjust his figures to account for the companies' disparate relative market shares. 8/23/07 Tr. 211:19-213:10 (Ciongoli). Thus, the relative expenditures are distorted.

97. SoundExchange also criticizes the use of the SDARS' musical works performance royalties as a benchmark on the basis that those rates are set "in the shadow of regulatory intervention." SX PFF ¶ 1408. But the fact that musical works performance rates are subject to governmental supervision and, like the rate being set in this proceeding, are required to be "reasonable," makes them more analogous to the rate to be set here than are rates set in the unfettered marketplace.

98. In sum, musical works royalties are a reliable benchmark for the sound recording performance right at issue here – certainly moreso than the non-music programming and Stern benchmarks on which SoundExchange relies.

## III. SOUNDEXCHANGE'S PROPOSED FINDINGS CONFIRM THAT A RATE GREATER THAN THAT PROPOSED BY THE SDARS WOULD RUN AFOUL OF THE SECTION 801(B)(1) STATUTORY OBJECTIVES.

### A. SoundExchange Concedes that Public Dissemination of Creative Works Is Relevant to the Availability Factor and that the SDARS Increase the Availability of Creative Works to the Public.

#### 1. Section 801(b)(1)(A) Requires Consideration of the SDARS' Contributions To Disseminating Sound Recordings.

99. SoundExchange's discussion of the first section 801(b)(1) objective – to "maximize the availability of creative works to the public" – ignores the fact that this is a compulsory rate-setting proceeding in which Congress has determined that the monopoly power of the copyright owner must be constrained in order to encourage the development of a new channel for disseminating copyrighted works to the public. *See* SDARS PCL Part III. As the Librarian stated in the 1998 proceeding: "Congress granted the record companies a limited performance right in sound recordings in order to 'provide [them] with the ability to control the distribution of their product by digital transmission,' but it did so with the understanding that the emergence of new technologies would not be hampered." Determination of Reasonable Rates and Terms for Digital Performance of Sound Recordings, 63 Fed. Reg. at 25,394, 25,399 (May 8, 1998) ("Librarian PSS Determination") (emphasis added).

100. Those new technologies, the 1995 Senate Report noted, "may permit consumers to enjoy performances of a broader range of higher-quality recordings than has ever before been possible. . . . Such systems could increase the selection of recordings available to

consumers . . . ." 1995 Senate Report at 14; 1995 House Report at 12; *see also* SDARS PCL ¶ 64. The SDARS have impressively realized Congress' vision. *See* SDARS PFF Part V.B.

101. As the SDARS explained in their Proposed Conclusions of Law, the section 801(b)(1) factors are not simply a verbose way of instructing the Judges to determine a sufficiently comparable "market" rate. *See* SDARS PCL Part III.B; SDARS Reply PCL Part II. A statutory royalty rate is "a mechanism whereby Congress implements policy considerations which are not normally part of the calculus of a marketplace rate," Librarian PSS Determination, 63 Fed. Reg. at 25,394, 25,409, which "rarely" corresponds to a marketplace rate, *id.*, SoundExchange's insistence in Part VI.A of its Proposed Findings of Fact that the "maximizing availability" factor is satisfied by requiring the SDARS to pay a "market rate," on the theory that it will provide an incentive to the recording industry to produce more sound recordings, does not comport with the law. Rather, the 801(b)(1) factors, both individually and collectively, require attention to the interests of all parties within the framework of the governing policy objectives. In the context of section 801(b)(1)(A), this mandates consideration of the role of the SDARS in making sound recordings (and other creative works) available to the public.

102. In an attempt to equate section 801(b)(1)(A) with "market rates," SoundExchange argues that satisfying this factor requires assuring a "fair return" to copyright owners. *See* SX PFF ¶¶ 789-93. But "fair return" to the copyright owner is addressed in section 801(b)(1)(B) (which also, not incidentally, requires consideration of a "fair income" to the copyright user). By focusing obsessively on maximizing its own compensation and the purported consequences that will flow therefrom, SoundExchange loses sight of the statutory objective – maximizing availability of creative works to the public – and of the SDARS' significant contributions to

fulfilling that objective with respect to sound recordings as well as a variety of other music and non-music content.

103. SoundExchange concedes, as it must, that "availability" encompasses both creation and dissemination of creative works. *See* SX PFF ¶ 773. Contrary to the thrust of SoundExchange's argument, there is no basis in the statute or in the governing precedents for limiting "dissemination" to only those actions undertaken directly by the copyright owner. Evaluation of this factor also must take account of the role of the copyright user in fostering dissemination of creative works.

104. In this regard, SDARS expert Professor Roger Noll explained that the "availability" criterion "refers to the use of a service by consumers and to the amount of creative product produced." Noll WRT at 41 (emphasis added). Availability, in other words, "refers to the ability of consumers to consume creative works," *id.* at 7, which has two elements: affordability and inducement. *Id.* SoundExchange – ignoring the section 114 compulsory license setting in which section 801(b)(1) must be construed – focuses solely, and erroneously, on the latter. With respect to inducement, moreover, as Professor Noll testified, SoundExchange has "failed to provide any empirical evidence about the magnitude of the inducement effect for record companies," *id.* at 46, relying instead on the speculation of Dr Herscovici, who testified, without having consulted any non-public information supplied by the record companies, that it was "hard to imagine" that the difference between the parties' rate proposals would not lead to stimulating creative activity. 8/30/07 Tr. 59:1-13, 15:3-14 (Herscovici).

### 2. SoundExchange Concedes that the SDARS Increase the Availability of Creative Works, Including Sound Recordings.

105. SoundExchange's discussion of section 801(b)(1)(A) contains no mention of the abundant record evidence demonstrating the manner in which the SDARS expand the availability

of a wide variety of musical and non-musical creative works through the original content they develop, produce, and broadcast to subscribers. *See* SDARS PFF ¶¶ 148-155.

106. Nor does SoundExchange, in discussing section 801(b)(1)(A), credit the SDARS for their substantial role in increasing the availability of sound recordings. Elsewhere, however, in attempting to underscore the "value" of sound recording performances to the SDARS, SoundExchange concedes the point. *See* SX PFF ¶¶ 458-59. Specifically, SoundExchange acknowledges that the SDARS "offer 'a much greater variety of music channels,'" *id.* ¶ 456 (citing 6/11/07 Tr. 65:7-12, 131:18-19 (Blatter), that the SDARS' music channels "provide a breadth and quality of music choice that is not and inherently cannot be provided by traditional radio," *id.* ¶ 458 (citing Blatter WDT ¶ 19, SIR Trial Ex. 36; that the SDARS, "provide[] access to music that listeners would otherwise never encounter," *id.* (citing Blatter WDT ¶ 24, SIR Trial Ex. 36); and that "Bluegrass, Broadway showtunes, 80's Hair Bands, Jazz, Blues, Classic Country and more are all available from the SDARS and not typically from terrestrial radio," *id.* (emphasis added). These admitted facts all clearly entitle the SDARS to credit under section 801(b)(1)(A).

107. In their Proposed Findings of Fact, moreover, the SDARS describe at length the important role they play in providing valuable and otherwise unavailable exposure for, in particular, new and niche artists – those most in need of finding an audience – which has, in some cases resulted in those artists signing recording contracts (*i.e.*, the creation of sound recordings). *See* SDARS PFF ¶¶ 292-317.

108. Given SoundExchange's forceful acknowledgement of the important role of the SDARS in furthering the availability of sound recordings, it is plain that SoundExchange's assertion that "with or without satellite radio sound recordings will be available to consumers on

more platforms and in more ways than ever before," SX PFF ¶ 810, does not address the relevant question of whether the SDARS make available particular sound recordings that consumers otherwise would not listen to or even know about. SoundExchange concedes that they do. *See* SX PFF ¶¶ 458-59. Indeed, SoundExchange expert Dr Herscovici opines that the importance of satellite radio "as a means of disseminating music is likely to grow significantly over time." Herscovici WRT ¶ 9.

109. Consumers obviously are not going to seek out and purchase music they "would otherwise never encounter," SX PFF ¶ 458, *i.e.*, music of which they have no knowledge. *See* Noll WRT at 58 (noting that a distribution channel that "expose(s) consumer to material that they otherwise would not know about" cannot possibly reduce, and may increase, sales of such music). The fact that a consumer can find ways to purchase an obscure bluegrass recording after hearing it on satellite radio – a purchase unlikely to occur absent the satellite radio performance – in no way diminishes the role played by satellite radio in making that recording available for listening.

110. SoundExchange would have the Judges ignore Professor Noll's testimony that the "availability" factor "favors rates that minimize retail SDARS prices so as to maximize the availability of satellite radio to consumers and thereby maximize the availability of music to them, within the limits imposed by the effect on inducing creative product and other statutory factors." Noll WRT at 42. The common-sense observation that keeping satellite radio affordable by not dramatically increasing its cost will allow more consumers to hear music on satellite radio refutes SoundExchange's assertion that lower costs for the SDARS will result in "no increased dissemination" of sound recordings. SX PFF ¶ 805.

111. SoundExchange's claim that there is "no plausible evidence that increased costs will cause satellite services to cease offering sound recordings," SX PFF ¶ 806, misses the mark and is contradicted by the sworn testimony of SDARS executives. While it is certainly true, as Dr. Herscovici testified, that a rate that would cause one or both of the SDARS to stop offering sound recordings altogether would be disruptive and would, by definition, reduce the availability of sound recordings to the public, *see* Herscovici WRT ¶ 88, the lesser consequence of causing the SDARS to reduce their use of sound recordings so as to manage their costs also would mean a decrease in the availability of sound recordings to the public. In this regard, Mr. Karmazin testified that if SoundExchange's rate proposal were adopted, Sirius would "have to dramatically scale back on the music programming that we offer." 6/6/07 Tr. 311:1-7 (Karmazin).

112. A rate that either would drive the SDARS out of business or cause them to reduce their performances of sound recordings also would deprive the recording industry of a powerful nationwide promotional vehicle that record companies, artists, and agents have eagerly sought to exploit for the exposure (and resulting sales) it provides. *See* SDARS PFF ¶¶ 285-91; 8/16/07 Tr. 43:4-10 (Noll) (testifying as to evidence that record companies "undertake costly expenditures to promote the playing of their sound recordings on satellite radio channels"); *id.* at 47:5-7 ("there's definitely evidence of promotion effect at the level of a label, at the level of a record company"). As Dr. Woodbury testified, "exposure . . . will tend to encourage the sale of music . . . thereby encouraging the production of new sound recordings." Woodbury AWDT at 44.

113. SoundExchange's plea for the additional revenue to help ease its transition to a digital-based business model is unsupported by any credible evidence that the SDARS have hurt, rather than helped, the recording industry's bottom line.

114. Given that the record companies continue to be successful businesses (*see* SDARS PFF ¶¶ 229-31) and that there is no evidence that the SDARS have any negative impact on those businesses (*id.* ¶¶ 239-41 (summarizing SoundExchange witnesses' testimony regarding causes of CD sales decline and their agreement that any decline predated the SDARS)), SoundExchange's effort to obtain "market rate" compensation from the SDARS on the theory that the recording industry must maximize its revenues from digital services to avoid reduction in the production of sound recordings is untenable. Similarly, there is no credible evidence that the SDARS' per-play rate proposal, with increases tied to subscriber growth, will lead to a diminution in the creation of sound recordings or a reduction in purchases of recorded music.

### B. SoundExchange's Rate Proposal Would Thwart the Purpose of the Section 801(b)(1) Fairness Objective by Forcing the SDARS To Incur Heavy Losses While Subsidizing the Already Profitable Recording Industry.

115. The SDARS already have demonstrated in their Proposed Conclusions of Law and Reply Conclusions of Law that the conceptual foundation of SoundExchange's entire discussion of section 801(b)(1)(B) – that the statutory term "fair return" requires the Judges to identify a "market rate" for sound recording performance rights and nothing more – is wrong as a matter of law. *See* SDARS PCL Parts III.B., IV.D; SDARS Reply PCL Parts II, III.D. Because the compulsory license framework that governs this proceeding is intended to strike a balance between the interests of copyright owners and those of the proprietors of new technologies, *see* SDARS Reply PCL Parts II, III.D, SoundExchange's argument that anything less than a market rate is unfair would effectively nullify section 801(b)(1) – the purpose of which (unlike the willing-buyer/willing-seller standard) is to constrain the market power of copyright owners so as to avoid stifling new forms of disseminating copyrighted works. *See* SDARS PCL Parts II, IV.D; SDARS Reply PCL Parts II, III.D.

116. Fairness to both parties as a matter of economic theory requires an assessment of whether the record companies are receiving a competitive return on investment sufficient to induce supply of sound recordings and whether the rate will allow the SDARS to generate risk-adjusted returns on their historical and forward-looking investments. *See* SDARS PCL Part IV.D. As to the former, the SDARS have explained that in the absence of any credible record evidence that the record companies are not earning a competitive return – *i.e.*, enough to induce the creation of sound recordings – or that the SDARS have displaced (as opposed to promoted) sales of sound recordings, there is no fairness rationale for a fee significantly above zero. *Id.* On the other side of the equation, the SDARS have shown that the confiscatory rates proposed by SoundExchange would prevent them from generating any net income, let alone the competitive return on investment that fairness dictates, until long after the license term, if at all, thereby undermining the incentive to invest in new technologies that section 801(b)(1) is intended to protect. *See* SDARS PFF Part V.C.

117. Nothing in SoundExchange's Proposed Findings of Fact – not the exaggerated claimed economic woes of the recording industry attributable to causes other than the SDARS; not the purported but unsubstantiated substitutional effect of the SDARS; and not the amount the SDARS pay to non-music content owners, from which they receive a host of benefits SoundExchange does not provide – responds to the foregoing or provides a fairness rationale for awarding SoundExchange a "market rate," much less the dramatically inflated "market rate" SoundExchange advocates.

### 1. There Is No Basis for Compensating SoundExchange Based on any Purported Substitution Effect.

118. SoundExchange's Proposed Findings of Fact attempt to demonstrate the existence of, and to quantify, an alleged substitution effect, which SoundExchange claims must be

considered in setting a reasonable royalty for the use of sound recordings. *See* SX PFF ¶¶ 669-725.[17] As discussed in the SDARS Proposed Findings of Fact, however, *see* SDARS PFF Part V.C, and further herein, the absence of any credible, quantifiable evidence of such substitution in the record here undermines the rationale for the SDARS to pay any compensation to SoundExchange.

119. As the SDARS demonstrated in their Proposed Findings of Fact, the evidence on which SoundExchange attempts to establish its claim of substitution (1) is demonstrably unreliable, (2) pertains only to listening, not purchasing, (3) does not pertain solely to listening to music on satellite radio, (4) is not quantified, or (5) has some combination of the above deficiencies. *See* SDARS PFF Part V.C.4.c. In addition to being based on unreliable data, Dr. Pelcovits' attempt to place a value on a purported substitution effect is indefensibly based on the alleged gross margins from CD sales for a single record company. Finally, SoundExchange's entire analysis of alleged substitution is inappropriately conducted at an industry, rather than company, level.

**a. SoundExchange's Evidence of an Alleged Substitution Effect Is Invalid, Pertains Only to Listening, and Provides No Basis for Quantification.**

**(1) The Mantis Survey**

120. In a telling admission of how weak SoundExchange's evidence of alleged substitution really is, the primary evidence relied upon by SoundExchange to establish the

[17] SoundExchange quotes Roger Noll for the proposition that fairness under the statutory standard requires SoundExchange to earn a competitive return on their investments including compensation for the decline in their returns that are caused by satellite radio. *See* SX PFF ¶¶ 832-39 (in particular citing Professor Noll). In quoting Professor Noll, however, SoundExchange omits Professor Noll's statements that "there is no evidence that record companies do not earn a competitive return on investment," and that "the SoundExchange economic experts present no empirical evidence that satellite radio either increases or reduces the revenues, costs and profits of record companies." Noll WRT at 55.

purported substitution effect is the Mantis survey. *See* SX PFF ¶¶ 675-93. The SDARS already have established the unreliability of that study. *See* SDARS PFF ¶¶ 246-64); SDARS PCL ¶¶ 159-74. To summarize: The Mantis survey had no control group and therefore could not show causation. *See* SDARS PFF ¶¶ 247-248. Its results (and the only claimed evidence of causation) depended entirely on an obviously leading question, which the survey responses confirmed. *Id.* at ¶¶ 249-55.[18] It confounded relevant and irrelevant time periods and imposed a difficult memory and mathematical test on respondents with nothing to establish the reliability of the responses obtained. *Id.* at ¶¶ 258-61. It did not even purport to isolate the effect of listening to music on satellite radio as opposed to other listening. *Id.* at ¶¶ 256-57. Finally, the survey depended entirely on Mr. Mantis' totally subjective coding. *Id.* at ¶¶ 262-63. For these and other reasons, the Mantis study provides no support for a quantification of a substitution effect.

**(2) The Excluded Wind Substitution Survey**

121. SoundExchange's next proffered support for its hypothesized substitution effect is euphemistically termed "economist testimony." SX PFF ¶¶ 694-95. A more candid heading would have been "second-hand reliance on excluded testimony," as this discussion is an attempt to shuttle in through the back door the Wind survey that the Judges excluded as unreliable. *See* 8/29/07 Tr. 101:11-102:4, 114:2-115:2 (Wind) (excluding Wind survey and testimony about that survey as unreliable).

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[18] SoundExchange's only oblique reference to the leading nature of the "control question" is to allege that such questions are "common" in marketing surveys and to suggest that there was no other way to ask the question. *See* SX PFF ¶ 683. As to the first point, there is simply no evidence in the record, nor any legal citation, to support the proposition. As to the second point, if there were truly no way to establish causation other than by asking a blatantly leading and suggestive question, then the particular survey methodology chosen simply does not work. Survey evidence is supposed to be well-designed and unbiased, not just the "least flawed" within a particular framework.

122. SoundExchange attempts to justify this end-run around the Judges' ruling by stating that Dr. Pelcovits and Dr. Herscovici reviewed and relied on the Wind survey. But, as SoundExchange well knows, and the Judges have ruled, while an expert may say he relied on something not in evidence, that does not mean that the contents of the document becomes admissible evidence. *See* 6/21/07 Tr. 93:1-97:9 (Ordover) (sustaining objection to admission of third-party exhibits relied on by expert based on Federal Rule of Evidence 703).

123. What makes this tactic especially improper here is the fact that the Wind study was excluded precisely because the Judges found it to be unreliable. Drs. Pelcovits and Herscovici both relied upon and cited to Professor Wind's written direct testimony as filed with the Court. *See* SX PFF ¶ 694; Pelcovits WRT at 31, SX Trial Ex. 24; Herscovici WRT ¶ 26. Professor Wind, however, twice found multiple errors in that testimony, including errors going to the final results of the survey itself. After denying SoundExchange's motion to amend the written direct testimony because it contained numerous substantial corrections, *see* 8/29/07 Tr. 101:11-102:2 (Wind), the Judges excluded the original survey. *See id.* at 113:22-115:2 (Wind). The apparent reason for this exclusion was that Professor Wind himself stated that he would rather rely on the amended results because they were more accurate. *See id.* at 110:7-113:12.

124. Notwithstanding this ruling, SoundExchange now not only proffers the excluded survey results but proffers them in their original form, which SoundExchange knows to be inaccurate. This tactic should be rejected and any evidence based on the Wind substitution survey not considered. SoundExchange's back-door proffer of the results of the excluded Wind substitution survey is particularly unfair, because had that survey not been excluded, Professor Wind would have been subject to extensive cross-examination concerning the numerous flaws

and limitations of that survey, as set forth in the SDARS' motion to exclude the survey on *Daubert* grounds.

**(3) Sirius and XM Surveys**

125. SoundExchange next discusses Sirius and XM studies. *See* SX PFF ¶¶ 696-99. As discussed below, however, the portions of these studies cited by SoundExchange concern changes in time spent listening, not purchasing. *See* SDARS PFF ¶¶ 276-81. Moreover, the surveys clearly show that by far the primary decline in listening after subscribing to satellite radio is associated with terrestrial radio, not with CDs or downloads. *See* SX Trial Ex. 35 at 26 (Sirius); SX Tr. Ex. 15 at 35 (XM); *see also* 8/29/07 Tr. 138:13-142:1 (Wind) (agreeing with same). This conversion of listeners from terrestrial radio to satellite radio results in the payment of royalties that SoundExchange otherwise would not receive, but Dr. Pelcovits fails to take this effect into account in his analysis. *See* SDARS PFF ¶¶ 276-81.

**(4) The NARM Study**

126. SoundExchange also relies on the NARM Study through the vehicle of the one section of Professor Wind's Written Rebuttal Testimony that was not excluded from evidence. *See* SX PFF ¶¶ 700-06. As established in the SDARS' Proposed Findings of Fact, however, there are no indicia of the reliability of this study in the record. *See* SDARS PFF ¶¶ 244-45. Professor Wind was unable to answer even basic questions regarding its methodology, and the underlying data were never admitted into evidence. Dr. Pelcovits likewise never even saw the full survey, and he did no analysis whatsoever of its methods. *See* 8/28/07 Tr. 185:18-21 (Pelcovits).

127. Notwithstanding the above, SoundExchange presents two charts purportedly showing results from the NARM survey (Figs. 33 and 34). Figure 33 shows the percentage of satellite listeners and others who did not purchase any music in the previous year. Figure 34

shows that satellite listeners were supposedly less likely than others to have purchased music in the previous year. Significantly, neither of these charts purports to show a causal link between satellite listening and music purchasing. The survey did not ask about behavior before and after purchasing satellite radio, so no "reduction" resulting from listening to music on satellite radio can be found or inferred. *See* SDARS Ex. 97.

128. Although SoundExchange refers to data purportedly showing that 84.7% of satellite radio users said that they purchased less music because they were "satisfied listening to the music on satellite radio," *see* SX PFF ¶ 703, this figure is drawn from a non-exclusive laundry list of possible reasons. From this list, respondents were free to check off as many as they saw fit. *See* 8/29/07 Tr. 155:6-156:9 (Wind); SDARS Ex. 97 at 12 (Questions 3 and 21, of which, both referenced by Professor Wind, ask the respondent to "select all that apply" among numerous potential responses). Thus, there is no way to determine what portion of any purchasing reduction (even if a reduction were shown, which it was not) is attributable to satellite radio as compared to other reasons that respondents identified. *See* 8/29/07 Tr. 155:11-156:15 (Wind).

### (5) The SDARS' FCC Filing

129. SoundExchange next attempts to rely on the SDARS' FCC filing and the attached CRA report. *See* SX PFF ¶¶ 673, 704-06. As an initial matter, that document was admitted only for the limited purpose of impeachment. *See* 8/22/07 Tr. 217:9-11 (Karmazin) (Judges limiting admission). Moreover, the focus of the document is on "changes in listening patterns," SX Trial Ex. 106 Ex. A at 12, and it is based largely on the same listening studies that, as described below, provide no information about purchasing. As Mr. Karmazin explained, substitution with respect to listening time does not suggest that satellite radio subscribers buy fewer CDs. *See, e.g.*, 8/22/07 Tr. 226:17-228:2 (Karmazin).

130. In addition, the document repeatedly emphasizes that the primary competitor of the SDARS for listening time – and the primary source of any "substitution" – is terrestrial radio. SX Trial Ex. 106 at 8, 37.

**(6) Other Alleged Evidence of Substitution**

131. Finally, SoundExchange cites conclusory testimony of record label executives as purported evidence of substitution. *See* SX PFF ¶¶ 707-13. None of this self-serving testimony, however – most from witnesses who disclaim knowledge of their own companies' promotional efforts – even purports to quantify a substitution effect. *See* 6/18/07 Tr. 184:22-186:3, 187:1-4 (Eisenberg) (disclaiming knowledge of Sony BMG promotion efforts); 6/27/07 Tr. 58:20-59:15, 95:8-98:5 (Kenswil) (disclaiming knowledge); SDARS PFF ¶¶ 282-84. In any event, none of this testimony undercuts the undisputed fact that record companies and artists engage in extensive and aggressive efforts to obtain air play and exposure on satellite radio for purposes of promoting their sound recordings. *See* SDARS PFF ¶¶ 282-317. In sum, despite SoundExchange's exhaustive efforts, there simply is simply no reliable, quantitative evidence of any substitution effect.

132. In sum, despite SoundExchange's exhaustive efforts, there simply is no reliable, quantitative evidence of any substitution effect.

**b. Dr. Pelcovits' "Quantification" of the Purported Substitution Effect Is Based Entirely on Unreliable Data.**

133. In his attempt to quantify a substitution effect, Dr. Pelcovits claims that the average satellite radio subscriber buys 2.6 fewer CDs per year. *See* SX PFF ¶ 720. While Dr. Pelcovits claims to have "reviewed" all of the sources discussed above, the only ones that

provide any such quantification are the Wind survey excluded by the Court as unreliable[19] and the Mantis Survey which, as demonstrated above, is at least equally unreliable. Thus, there is no reliable record evidence supporting this critical assumption.

134. Dr. Pelcovits' calculation of a $1.29 substitution effect per subscriber per month also is based on another critical input – the incremental record-label profit on the sale of a CD, which he asserts is [[ ]]. However, this was determined "solely with respect to [one] company" that admittedly was used by Dr. Pelcovits as a "proxy for the entire industry." 8/28/07 Tr. 174:3-16 (Pelcovits). This calculation also was based only on full-price CDs and never was properly adjusted to reflect the different price points and margins of other CD lines. *Id.* at 178:20-179:3. There is no record evidence as to the incremental margins at other record companies, nor was the basis disclosed for the one figure that is in the record. As such, there is no reliable basis for the industry-wide calculation that Dr. Pelcovits purports to present.

**c. As Demonstrated by Professor Noll, SoundExchange's Analysis Is Improperly Conducted at an Industry, Not Company, Level.**

135. Finally, as Professor Noll testified, it is improper to conduct a substitution analysis at an industry level, as Dr. Pelcovits purports to do. As Professor Noll testified, a proper analysis of substitution would only consider the effect upon an individual firm when negotiating a license fee for its copyrights; analysis at an industry level is tantamount to treating the recording industry as a cartel. *See* 8/16/07 Tr. 43:21-44:9 (Noll); Noll WRT at 66; SDARS PFF ¶¶ 265-66. SoundExchange has no answer to Professor Noll's testimony on this point. Thus, Dr. Pelcovits' calculation is not only based on unreliable evidence but improper as well.

[19] SoundExchange also suggests Dr. Pelcovits relied on another analysis that was excluded. SX PFF ¶ 720; 7/9/07 Tr. 9:16-17:5 (granting motion to strike). There is no apparent connection between the non-stricken testimony and the 2.6 figure used in Dr. Pelcovits calculation, however.

### 2. SoundExchange's Reliance on the Claimed Struggling State of the Recording Industry Is Misplaced.

136. SoundExchange complains that the recording industry has subsidized the SDARS and that fairness requires a market rate to avoid further subsidies that SoundExchange claims would "put[ ] the future of the record industry at risk." SX PFF ¶ 825-826 (quoting Edgar Bronfman). The evidence shows, however, not only that SoundExchange has overstated the risks as it transitions to a digital business model, but also that the rate SoundExchange has proposed will force the SDARS to subsidize that transition and will deprive the SDARS of any income during the license term. Such a rate is not only unfair but an unwarranted expropriation of the SDARS revenues.

#### a. The Recording Industry's Transition to Reliance on Digital Sales Does Not Warrant Increased Compensation from the SDARS.

137. SoundExchange claims that given the current financial state of the recording industry, fairness requires maximizing the fee from the SDARS to help the recording industry to compensate for declining CD sales. *See, e.g.*, SX PFF ¶¶ 140-145, 147, 151, 152, 162-163. The SDARS already have shown that notwithstanding the transition the recording industry is undergoing, record companies remain profitable, and digital revenues are increasing dramatically. *See* SDARS PFF ¶¶ 229-231.

138. In that regard, it is worth noting that because the recording industry's physical sales peaked in 2000, as a result of consumers replacing LPs and cassettes with CDs (*see* SDARS Ex. 35 at SE 0214037), the current state of the record business is not so much a decline as a return to the level of sales in the early 1990s. *See* SDARS Ex. 99 (showing total physical sales of 9.024 billion in 1992 and 9.651 billion in 2006).

139. Moreover, the record companies themselves have stated the obvious: that the decrease in sales since 2000 *i.e.*, prior to launch of the SDARS, *see* SDARS PFF ¶¶ 240-41 (noting testimony of SoundExchange witnesses agreeing that decline predated the SDARS) has been primarily driven by factors other than the SDARS: digital piracy, bankruptcies of record retailers and wholesalers, growing competition for consumer dollars, and changing tastes. SDARS Ex. 35 at 15, 21, 47 (Warner Music Group ("WMG") 2006 10-K, describing downturn of industry); 6/26/07 Tr. 155:4-6 (Kushner) (stating that piracy has been the primary cause of the sales decline), *id.* at 170:14-18 (acknowledging that tastes change); SDARS PFF ¶¶ 239-41 (summarizing SoundExchange witnesses' testimony regarding true causes of CD sales decline). This fact surely undermines any fairness rationale for expropriating the SDARS' revenues.

140. In any event, the record shows that the recording industry's transition to digital distribution is going smoothly. Despite SoundExchange's claim that CD sales are declining, the recording industry is very stable and is experiencing huge growth in the areas that are expected to drive its future revenues. *See* SDARS PFF ¶¶ 229-36. Indeed, while the decline in physical sales has happened relatively slowly (CD shipments declined at a compound annual rate of approximately 6% between 2000 and 2006), the growth rate of digital sales has been astronomical (growth at a compound annual rate of 218% between 2004 and 2006). *See* Herscovici WRT at App. B, C, D. This trend is only expected to continue. SDARS Ex. 56 at SE 0125770 (projecting that, industry-wide, digital album sales will increase 38% and digital track sales will increase 37% in 2007 over 2006 figures, as compared to a 5% decline in CD sales).

141. SoundExchange seeks to downplay this growth by citing Sony-BMG's declining revenues from 2000-2006 as evidence of the entire recording industry's poor health. *See* SX PFF ¶ 152. But the evidence shows that Sony-BMG is an outlier: from 1999 to 2006, UMG earned a

profit in each year, while WMG's revenues grew from $3.437 billion in 2004 to $3.516 billion in 2006. SDARS PFF ¶¶ 229-30. And Sony-BMG itself actually turned a profit of $10.3 million in 2006. *Id.* ¶ 231.

142. SoundExchange also heavily relies on the testimony of Atlantic Recording Corp.'s Michael Kushner in support of its tale of recording industry doom and gloom. SX PFF ¶¶ 156, 158-63. But as noted in the preceding paragraph, the revenues of Atlantic's own parent label, WMG, actually increased by nearly $80 million from 2004-2006.

**b. Fairness Does Not Require the SDARS To Help Make Up for Declining CD Sales.**

143. SoundExchange argues repeatedly that the rate set in this proceeding must be calculated to help the record companies "mak[e] up for" the profits they would have earned had CD sales not been in decline. *See* SX PFF ¶¶ 33, 146-147, 150, 155-160, 164, 173, 834, 1250; Kenswil WDT at 2-3 ("We at UMG are hopeful that the revenues from all of these uses of music will, in the long run, more than compensate for any lost physical sales."); 6/27/07 Tr. 17:19-18:11 (Kenswil) (declaring hope that new revenue streams "would more than replace the lost CD sales"). But there is no fairness rationale for the Judges to set a rate for the SDARS pegged to a profit level associated with an outdated business model.

144. First, the CD album format generated huge profit margins for the record companies. Mark Eisenberg testified that Sony BMG's gross profit margin on a top-line CD is currently [[ ]]. Eisenberg WRT at 12. A record company, however, makes a profit of [[ ]] for each single-track download from iTunes, and an average of approximately [[ ]] per downloaded album. 6/18/07 167:3-7, 169:3-8 (Eisenberg). Therefore, assuming 10 tracks per CD, as Dr. Pelcovits does, *see* Pelcovits WRT at 31, permanent audio downloads are [[ ]]. Indeed, WMG has expressly acknowledged as much to

the SEC and its investors, stating in its annual report that "it is reasonable to expect that we will generally derive a higher contribution margin from digital sales than physical sales." SDARS Ex. 35 at SE 0214031. In some instances, the sales of digital products has already made up for the decline in the sales of physical products. *See* SDARS Ex. 56 at SE 0125767 (showing that this is true as to UMG artists Metallica and Linkin Park).

145. It may be that, as Atlantic Records executive Michael Kushner testified, the CD business model is outdated, the future of the industry is in "single track downloading" and his label is nevertheless "fighting to maintain the album model for the purposes for which it is best suited." 6/26/07 Tr. 160:5-7, 161:1-3 (Kushner). But it would be fundamentally unfair for the SDARS, which have played no causal role whatsoever in the decline of the CD and, to the contrary, helped to promote CD sales, *see* SDARS PFF ¶¶ 282-317, to be required to contribute to ameliorating the consequences of the recording industry's having "realized too late" that it cannot resuscitate the obsolete physical business model in the digital era. *See* 6/27/07 Tr. 17:8-14 (Kenswil); *see also* 6/26/07 Tr. 65:19-66:6; 67:10-13; 68:12-20; 69:20-70:5; 74:5-20 (Chmelewski) (conceding, when questioned by the Judges, that the decline in CD sales is likely attributable to a change in the industry that is making the physical product business model obsolete).

146. In sum, nothing in section 801(b)(1)(B) justifies saddling a newly emerging communications technology that has yet to generate any net income at all with the burden of offsetting the effects of the recording industry's business circumstances that have nothing to do with satellite radio.

### 3. Fairness Does Not Support Awarding SoundExchange Fees Commensurate with Contract Amounts Paid to the SDARS' Non-Music Content Providers.

147. A prominent theme sounded in SoundExchange's submissions is that it is unfair for the recording industry not to be compensated equally with the SDARS' non-music content providers: Howard Stern, Oprah Winfrey, NFL, MLB, etc., given the importance of "music" to the SDARS' businesses. *See, e.g.*, SX PFF ¶¶ 827-28, 1126-1137. For the many reasons explained in the SDARS' Proposed Findings of Fact and elsewhere in these Reply Findings, SoundExchange's argument that "content is content" and that it all should receive the same price ignores numerous significant benefits (including trademark and brand exploitation rights, endorsement and promotion rights, exclusivity, and publicity) obtained by the SDARS from its non-music programming deals but not from SoundExchange. *See* SDARS PFF Parts VII.C.2, VII.D.4-5; SDARS Reply PFF Part V.A.2. There is no basis in any theory of economic fairness for paying SoundExchange the same as entities from which the SDARS obtain valuable additional rights. As Mr. Karmazin explained: "More rights gets you more money. Less rights gets you less money." 8/22/07 Tr. 176:2-3 (Karmazin).

## C. SoundExchange Failed To Use the Proper Standard in Assessing Relative Contributions.

148. Contrary to SoundExchange's assertions throughout its Proposed Findings of Fact (*see* SX PFF ¶¶ 350, 842, 843, 845), the proper analysis under section 801(b)(1) requires consideration of the relative contributions of the respective parties to "the product made available to the public," *i.e.*, satellite radio services, not the relative contributions made to the sound recordings that comprise a part of those services' offerings. *See* SDARS PCL ¶¶ 74-75. SoundExchange itself has recognized the correctness of this focus in averring that the "product

produced by the SDARS is a broadcast that can be received by special radios, especially in cars, and that both music and non-music content are inputs into that product." SX PFF ¶ 538.

### 1. The Creative Contributions Subfactor Weighs in Favor of the SDARS.

149. As explained in detail in the Parts IV and V.D of the SDARS Proposed Findings of Fact and ¶¶ 77-84 of the SDARS' Proposed Conclusion of Law, the SDARS make significant creative contributions to the satellite radio product. Their programming includes more than mere pass-through content or a compilation of the creative works of others. On both their music and non-music channels the SDARS develop and program original content that did not previously exist. SDARS PFF ¶¶ Part V.D. In broadcasting their music channels the SDARS program original content, broadcast live musical performances, select and train celebrity on-air talent, make recommendations to subscribers regarding listening choices, create music libraries and develop broadcast criteria specific to customer's preferences and feedback. *See* SDARS PFF ¶¶ 369-419. The SDARS also make extensive creative contributions to their satellite radio service through their non-music programming efforts, including original news, talk and entertainment program as well as unique and inventive sports programming. *See* SDARS PFF Part V.D. This original programming is a substantial creative contribution to the overall satellite radio product and is as important, if not more important than the sound recordings that the record companies provide.

150. As described in detail in Part VII.A of the SDARS Proposed Findings of Fact and in the SDARS' Proposed Conclusions of Law (¶ 83) (and in Hauser WRT, Ex. M), the SDARS have provided extensive evidence that the programming features they contribute to their music and non-music channels, including those listed above, are important to subscribers. This contribution both attracts subscribers to the SDARS services and helps retain those subscribers.

This evidence distinguishes the SDARS' contribution from the scant "contributions" in *National Association of Broadcasters* and *1980 Cable Royalty Distribution.* Subscribers' willingness to pay for the service alone shows that the SDARS creative contributions to the content are extensive. If an attribute of the programming "improves the quality of programs, and thus people are more likely to want to [listen to] those programs, even though they may not choose to do so exclusively because of" that attribute, those contributes do have value, and should be considered, as a creative contribution, SoundExchange's contrary argument notwithstanding. *See* 772 F.2d at 934.

151. As discussed above, the product at issue in this rate proceeding is the SDARS' overall satellite radio services, of which the sound recordings created by the record labels are one programming input. Although the efforts of the artists and musicians, as well as some efforts of record companies, contribute to the creation of those sound recordings, not all work done by the record labels in their day-to-day business relates to the creation of those sound recordings as SoundExchange's Findings of Fact suggest.

152. For example, SoundExchange attempts to include among its "creative contributions," negotiating recording contracts (without consideration to those many SoundExchange clients who are the artist on the other side of this negotiation) (SX PFF ¶ 866); creating album art, websites, interactive media, animation and videos associated with sound recordings that are immaterial to radio performance (*id.* ¶¶ 875, 885); creating of bonus tracks that are included on CDs to entice the purchase of physical copies yet are not broadcast on the SDARS (*id.* ¶ 870); marketing sound recordings to promote sales to the public (*id.* ¶¶ 886-91); and arranging touring and tour logistics for live performances that are not broadcast on the

SDARS. (*id.* ¶ 897). None of these relates directly to the sound recording performance right being licensed to the SDARS.

### 2. The Technological Contributions of the SDARS

153. With respect to this factor, SoundExchange presented no facts regarding any relevant technological contribution by its constituents, thereby conceding that the contributions of the SDARS outweigh the non-existent contributions of the copyright owners.

154. SoundExchange nevertheless seeks to diminish the substantial technological contributions made by the SDARS to their pioneering satellite radio services by misreading the statute to require technological "innovation" and then adopting an untenably narrow view of whether the technological advances, described in detail by the SDARS in their Proposed Findings of Fact, *see* SDARS PFF Part V.E, constitute innovations. However, SoundExchange's attempt to explain away the SDARS technological contributions is undermined by statements of its own expert witness, Bruce Elbert, who in his testimony in this proceeding and elsewhere has acknowledged the SDARS' advances beyond prior satellite communications systems, as well as by their often misleading presentation of the record evidence.

155. SoundExchange begins its argument in misleading fashion by asserting that "an internal SDARS document" concedes that "[t]he technology to produce a subscription SDARS has been available for about a decade." SX PFF ¶ 902 (*citing* SDARS Trial Ex. 92, at 251). The quoted language comes not from an "internal SDARS document," but, rather, is an out-of-context excerpt from a textbook authored by SoundExchange's own expert, Bruce Elbert. *See* SDARS Ex. 92. The omitted remainder of the sentence reveals Mr. Elbert's acknowledgement that "the pieces first came together with the launch of XM Satellite Radio in the United States in March 2001." *See* SDARS Ex. 92 at 251 (emphasis added). This comports with Mr. Elbert's trial testimony that "no one before XM or Sirius had ever developed a commercial nationwide

system that combined the elements of multiple satellites with simultaneous broadcasting and terrestrial repeaters and moderately priced receivers with the ability to combine those signals and produce real-time listening quality in automobiles." *See* 8/27/07 Tr. 210:1-9 (Elbert); *see also* 6/7/07 Tr. 45:20-46:18 (Smith) (SDARS were the first service to send seamless digital audio content from a satellite to a moving vehicle). It is this identification, assembly, enhancement, and integration of these "pieces" that created what Mr. Elbert acknowledged was "an advancement over prior commercially available systems," 8/27/07 Tr. 215:16-21 (Elbert), and hence a technological contribution for purposes of section 801(b)(1)(C).

156. As noted, SoundExchange attempts to deprive the SDARS of credit for the many technological contributions to their first-of-a-kind services by misreading the statute as requiring technological "innovation," which Mr. Elbert defines as "a technology that has not existed, that has been invented." He posits that "a system that integrates together a number of existing proven technologies" would not qualify as such an innovation. 8/27/07 Tr. 198:7-199:6 (Elbert). But his admission that the SDARS used pre-existing components along with "a very good engineering job" that required "detailed systems development that had not occurred in that form for a commercial nationwide system before" and ultimately "produced a successful system" which constituted "an advancement over prior commercially available systems," *id.* at 199:1-6, 211:4-9, 215:16-21, 218:10-13 (Elbert), surely constitutes "technological contribution" under any reasonable understanding of the term, whether or not it rises to the level of what Mr. Elbert would deem "innovation."

157. SoundExchange argues that the SDARS' technological contributions in developing the satellite radio business are "grossly overstated." SX PFF ¶ 929. This contention is contradicted, however, by the fact that XM and Sirius hold a total of some 60 patents for their

innovations in the areas of system architecture, the architecture of the orbital configuration, chipset and receiver design, and antenna characteristics. 8/27/07 Tr. 219:5-221:6 (Elbert). *See* SDARS PFF ¶ 510 (noting over 60 patents held by the SDARS); Woodbury AWDT at 49:27-30; Masiello WDT ¶ 12. If anything is overstated, it is SoundExchange's attempt to downplay the SDARS' innovations.

**a. SoundExchange Overstates the SDARS' Reliance on Precursor Satellite Systems.**

158. In developing its theme that the SDARS simply utilized existing technology in a new way, SoundExchange refers to "precursor satellite systems" that included "the important technological elements of the SDARS systems." SX PFF ¶ 913. But Mr. Elbert conceded that "no one before XM or Sirius had ever developed a commercial nationwide system that combined the elements of multiple satellites with simultaneous broadcasting and terrestrial repeaters and moderately priced mobile receivers with the ability to combine those signals and produce real-time listening quality in automobiles." *See* 8/27/07 Tr. 210:1-9 (Elbert). In fact, the development of the SDARS' infrastructure marked the first time that dual satellites were integrated with a terrestrial-based repeater network in any satellite business. *See* 6/5/07 Tr. 99:13-22; 100:1-2 (Parsons).

159. SoundExchange also asserts that the WorldSpace system also used a "portable receiver" with a "'relatively small satellite receiving antenna'." SX PFF ¶ 911. But SoundExchange fails to explain what Mr. Elbert himself admitted: the WorldSpace receiver was only "portable" in the sense that it could be moved from place to place. However, the receiver would only receive the signal if it was "still point[ed] at the satellite." One could not "move around with [the receiver] in the back of a pickup truck, other than very open areas, and expect it to work if you went into a city." 8/27/07 Tr. 205:7-21 (Elbert).

160. SoundExchange also provides only part of the story in its effort to liken the technology used by the SDARS to that used previously by DBS television services like DirecTV. *See* SX PFF ¶¶ 916-919. For example, SoundExchange fails to note that, unlike satellite television providers, the SDARS were faced with the challenge of delivering continuous broadcast to moving vehicles and other portable devices. *See* 8/27/07 Tr. 209:18-22 (Elbert); 6/7/07 Tr. 45:20-46:18 (Smith). Unlike DirecTV, the SDARS could not use a sizeable antenna in a fixed position carefully positioned towards the location in the sky where the satellite is located. *See* 6/4/07 Tr. 311: 15-20 (Parsons). In fact, XM has developed an antenna so small that one of a similar size is currently in use by no other satellite service. *See* 6/4/07 Tr. 320:12-18 (Parsons).

161. SoundExchange also tries to equate the SDARS with Iridium and GlobalStar, claiming that both "delivered working mobile [satellite] telephone service to individual handheld units slightly larger and heavier than a cellular phone." SX PFF ¶ 914. Mr. Elbert conceded, however, that the Iridium receivers were "too big and bulky" and acknowledged that this was a factor in Iridium's eventual bankruptcy. 8/27/07 Tr. 244:5-245:6 (Elbert); *see also* SDARS PFF ¶ 456.

162. Mr. Elbert also acknowledged that Iridium receivers were prohibitively expensive ($2,000) and that one of the successes of the SDARS was that "they managed to get receivers that were inexpensive enough that they were able to get them out there with a substantial subscriber base." 8/27/07 Tr. 244:13-246:3 (Elbert). He also recognized that in order to achieve this success, XM set up an in-house technical development center focused on "designing and qualifying low-cost, high-performance radios and miniaturized antennas." *Id.* at 243:6-14; *see also* SDARS PFF ¶ 456. Both Iridium and Globalstar phones, on the other hand, were far too

expensive for the average consumer and both companies eventually went bankrupt, despite having "substantial technical breadth and depth in mobile communications design." 8/27/07 Tr. 243:15-245:3 (Elbert).

**b. XM and Sirius Developed Unique Nationwide Subscription SDARS Services Not Previously Available.**

163. SoundExchange makes liberal use of truncated citations to trial testimony to present a distorted picture of the technological advances for which the SDARS were responsible. For example, SoundExchange misrepresents Anthony Masiello's testimony as having conceded that the Hughes 702 was "a basic satellite that Hughes (now a part of the Boeing Company) offers." SX PFF ¶ 922. Mr. Masiello made no such concession; he instead explained that "the innovation here is the amount of electrical power that this satellite generates, the largest amount that's available. And the payload or the business side of what the satellite is doing also has to be specifically developed, if you will. Technical advances in the science of satellite were necessary." 6/6/07 Tr. 207:5-22 (Masiello).

164. As Mr. Masiello explained, XM went to Hughes with its design specifications and Hughes designed the satellite "in conjunction with [XM's] folks, as well, providing input because [XM] understood [its] system." 6/6/07 Tr. 233:11-234:1 (Masiello). Thus, XM participated in the design and specifications of its satellites.

165. SoundExchange further claims that XM did not design its own satellites' payload and asserts that Alcatel had previously built the payload for WorldSpace, but it fails to note that the XM payload was larger and more powerful than that of WorldSpace. 6/6/07 Tr. 235:2-7 (Masiello). The collaboration between Boeing and WorldSpace to create such a high-powered, concentrated payload marked the first time that Boeing and Alcatel had partnered on such a project. *See* 6/5/07 Tr. 98:22-99:12 (Parsons).

166. SoundExchange's assertion that "XM was able simply to purchase many of the components of its satellite system easily from other companies," SX PFF ¶ 921, lacks any record support. SoundExchange overlooks the difficulty faced by the SDARS in conforming existing components to the necessary specifications for the XM and Sirius systems.[20] Indeed, Mr. Elbert recognized that the design and development of the SDARS required "detailed systems development that had not occurred in that form for a commercial nationwide system before." 8/27/07 Tr. 211:4-9 (Elbert).

167. SoundExchange contends that "the SDARS' antennas are not innovative" because they are based on 40-year old engineering principles and paper designs found in engineering literature. SX PFF ¶ 931. But the reduction in the size of the antenna was a major developmental milestone for XM. *See* Masiello WDT ¶ 33. It took five to six years of design effort for XM to develop an omni-directional antenna so small that one of a similar size is currently in use by no other satellite service. *See* 6/4/07 Tr. 320:9-18 (Parsons); 6/6/07 Tr. 217:15-17 (Masiello). Likewise, the Sirius antennas have today been reduced in size to 47 mm by 40 mm by 12 mm. Smith WDT ¶ 26. The reduction in the size of the antenna has allowed the SDARS to create portable receivers with a larger appeal than the "big" and "bulky" and

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[20] SoundExchange also seeks to minimize the risks faced by the SDARS in developing this new medium for delivery for sound recordings, specifically downplaying the risk of launch and in-orbit failure. *See* SX PFF ¶¶ 948-64. The SDARS addressed these risks extensively in their Proposed Findings of Fact. SDARS PFF ¶¶ 622-703. In any event, SoundExchange's arguments run up against the fact that its own technology expert, Bruce Elbert, conceded at trial that "the placement of communication satellites into service is inherently a risky business" 8/27/07 Tr. 223:4-21 (Elbert). Mr. Elbert also has written that there is a "probability of approximately 10% that the satellite will not reach its specified orbit and provide service." SDARS Ex. 92 at 101 (textbook chapter entitled "Risks of Satellite Operation"). Indeed, Mr. Elbert well encapsulated the risks faced by the SDARS in developing their systems when he wrote that "[t]here are risks in this market, as demonstrated by failed projects discussed elsewhere" and that for the SDARS "[b]ecoming a mainstream service taken by millions of paying subscribers is still only an expectation at best or dream at worst." SDARS Ex. 92 at 282 (published in 2004).

prohibitively expensive (approximately $2,000) receivers used by Iridium. *See* 8/27/07 Tr. 244:5-245:6 (Elbert); *see also* SDARS PFF ¶¶ 453-56, 498. As noted, Mr. Elbert acknowledged that the reduction in size and cost of receivers is a success of the SDARS. *See id.* 244:13-246:3.

168. SoundExchange tries to diminish one of the most important technological contributions of the SDARS: the use of terrestrial repeaters. Again, SoundExchange mischaracterizes the record in claiming that XM's Mr. Masiello admitted that repeaters were "not a new concept" and have "been around for awhile." SX PFF ¶ 937. In fact, Mr. Masiello testified that the use of repeaters by the SDARS was a significant innovation:

> [R]epeaters and devices that act as repeaters have been around for a while, but the real key important part here is that technologies, waveforms had to be developed because you have the satellite and the repeaters operating within the same frequency band, one actually causing interference to the other. So waveform and the frequency allocation and spectrum allocation tables had to be developed to actually mitigate [the] self-generated interference. And that's really what's unique about what Sirius does and about what [XM does] with satellites and repeaters, so its not like your typical cell site where the cells just touch each other.

6/6/07 Tr. 209:5-209:21 (Masiello). Mr. Masiello also noted that the development of the SDARS marked the first time such a system had been used. *Id.* at 210:5-9. Moreover, by using repeater networks, the SDARS were the first commercial satellite businesses to provide continuous satellite programming content to mobile consumer devices in urban areas where satellite signals would have been blocked. 8/27/07 Tr. 209:18-210:9 (Elbert); *see also* 6/7/07 Tr. 43:9-46:18 (Smith).

169. SoundExchange also ignores the SDARS technological contributions in developing chipsets, which enable their radios to choose the strongest signal from any of the transmitting satellites or repeaters. Smith WDT ¶¶ 22-24. SoundExchange's own expert admitted that Worldspace, for example, lacked circuitry this advanced. Elbert WRT at 29; *see also* 6/4/07 Tr. 316:17-22, 317:1-21 (Parsons); *see also* SDARS PFF ¶¶ 448-49, 451-52, 495-96.

170. The SDARS chipsets are also important because to enable SDARS radios to "receive, decode, and decompress" the complex satellite signal." Smith WDT ¶ 24. SoundExchange attempts to claim that the audio compression techniques that create these complex signals are not innovative and have been applied since the 1970s. *See* SX PFF ¶ 936. Although the SDARS do not claim to have invented audio compression, the advances they made by using audio compression have been remarkable. Indeed, despite originally expecting to be able to broadcast only thirty to forty channels, as a result of advances the SDARS have made in audio compression, both companies now broadcast over 130 channels. 6/7/07 Tr. 78:4-15 (Smith); *see also* SDARS PFF ¶¶ 444-45, 503.

171. This innovation is even more impressive given that the SDARS' modest amount of spectrum. 6/7/07 Tr. 44:2-16 (Smith). Unlike DirecTV, which has the luxury of a "wider bandwidth and spectrum," *id.* at Tr. 71:6-7, and can spread the broadcast of its channels over a number of signals, the SDARS have to send all of their channels in one signal. *Id.* at Tr. 70:7-72:20.

172. SoundExchange's efforts to belittle the technological contributions of the SDARS – without citing any evidence of any such contributions by its own constituents – amount to nothing more than listing countless references by Mr. Elbert to prior companies he considers more innovative than the SDARS without regard to the SDARS' actual technological contributions to the product made available to the public. The following chart lists the "comparable" companies described by Mr. Elbert, and the features he indicated they were required to include to offer their services[21]:

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[21] Elbert WRT at 24-26, 34, 37 (discussing features of Iridium and GlobalStar); 8/27/07 Tr. 243:15-245:3 (Elbert) (same); 6/7/07 Tr. 122:3-20 (Smith) (same); SX PFF ¶ 907 (discussing features of DirecTV and Dish); Smith WDT ¶ 4 (same); Elbert WRT at 7-8, 11-12, 14, 17, 27-29, 35, 38-39; 8/27/07 Tr. 205:11-15, 209:18-210:9 (Elbert) (same); 6/7/07 Tr. 68:4-6

| | Mobile Service | Constant Stream of Programming | Multiple Channels of Programming | Use of Multiple Satellites | Use of Satellites to transmit directly to receiver | Use of Repeater Network | Antenna Size Similar to SDARS | Omnidirectional Antenna | Antenna Receives Signal From Satellite and Repeater | Receiver Chooses Strongest Satellite or Terrestrial Signal | Priced for Average Consumer | Individual Consumer Acceptance |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **SDARS** | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ |
| Irridium and Globalstar | √ | | | √ | √ | | | √ | | | | |
| DirecTV and Dish Network | | √ | √ | | √ | | | | | | √ | √ |
| Supermarket Radio | | √ | √ | | | √ | | | | | | |
| Worldspace | | √ | √ | | √ | | | | | | √ | √ |
| GPS Receivers | √ | | | √ | √ | | √ | √ | | | | |
| NASA | √ | | | √ | √ | | | √ | | | | |
| Cellular Telephone Services | √ | | | √ | | √ | √ | √ | | | √ | √ |
| United States Army | √ | | | √ | | √ | | | | | | |
| Western Union | | √ | √ | √ | | | | | | | | |
| NPR | | √ | | √ | | √ | | | | | √ | √ |
| Hughes Satellite and Space Systems Loral | √ | √ | | √ | √ | | | | | | | |

As this chart demonstrates, the SDARS were the first companies to combine a multitude of features to create a digital mobile radio service provided by satellite that consumers pay to obtain, none of which would have been possible absent the SDARS significant technological contributions and innovations.

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(Smith) (same); 8/27/07 Tr. 205:11-15 (Elbert) (discussing features of Supermarket Radio); Elbert WRT at 1, 24, 34 (same); 8/27/07 Tr. 204:21-205:21, 209:18-210:9 (Elbert) (discussing features of Worldspace); Elbert WRT at 6-7, 9, 20, 28-30, 35 (same); SX PFF ¶ 932 (discussing features of GPS systems); 8/27/07 Tr. 189:8-14 (Elbert) (same); 6/7/07 Tr. 123:11-124:3 (Smith) (same); Elbert WRT at 20, 27, 31-34 (same); SX PFF ¶ 909 (discussing NASA experiments); 8/27/07 Tr. 208:4-209:5 (Elbert) (same); Elbert WRT at 8, 21, 26, 30-31, 37 (same); 6/6/07 Tr. 209:5-210:4 (Masiello) (discussing features of cellular telephones); Elbert WRT at 26-27, 32, 34-35 (same); SE PFF ¶ 938 (discussing uses of repeater networks by United States Army); Elbert WRT at 34 (same); Smith WDT ¶ 26 (same); SX PFF ¶ 904 (discussing features of Western Union satellites); 8/27/07 Tr. 154:10-17, 183:20-184:10, 187:8-20 (Elbert) (same); Elbert WRT at 23, 28; SX PFF ¶ 904 (discussing use of satellites by NPR); 8/27/07 Tr. 155:14-18, 184:3-10, 185:11-18 (Elbert) (same); Elbert WRT at 23, 34; SX PFF ¶¶ 920-928, 935 (discussing experiences and features of Hughes Satellite and Space Systems Loral); Elbert WRT at 21, 23-24 (same).

### 3. SoundExchange Has Understated the SDARS' Investments, Costs and Risks and Overstated the Record Companies'; Moreover, It Is Clear that the Relative Balance of Capital Investments, Costs, and Risks Falls Squarely in the SDARS' Favor.

173. The record evidence reveals that Section 801(b)(1)'s mandate that the rate "shall be calculated" to reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to capital investment, cost and risk, is met by a lower, rather than a higher, rate in this case. SoundExchange attempts to avoid the implications for section 801(b)(1)(C) of its far smaller (indeed, virtually nonexistent) contribution to satellite radio in terms of investments made, costs incurred, and risks assumed than the SDARS themselves by asserting that "it is necessary to consider all of the record companies' investment, cost, and risk – not simply some subset that is attributable to satellite radio" SX PFF ¶ 972 – in evaluating relative contributions to "the product made available to the public." 17 U.S.C. § 801(b)(1)(C). However, as demonstrated in the SDARS' Proposed Conclusions of Law, *see* SDARS PCL ¶¶ 74-75, the relevant product is not sound recordings, as SoundExchange would have it, but the SDARS' services as a whole, for which post-1971 sound recordings are but one input. SoundExchange has actually begrudgingly agreed that this is true. *See* SX PFF ¶ 538.

174. Moreover, if this factor is not to tip invariably in favor of the recording industry – a result that would conflict with Congress' intent to encourage investment in new technologies – it must entail evaluation of investments, costs, and risks incurred specifically in connection with the service in question. If all that the third section 801(b)(1) factor entailed was a comparative measurement of the magnitude of the investment, and associated risk, undertaken by the recording industry as a whole without regard to the product or service for which fees are to be set, there would be no point in engaging in the exercise at all: the recording industry exceeds the scale of the SDARS and every other section 114(1) statutory licensee by many multiples. The

statute is clear, however, that as a matter of law, SoundExchange cannot place the anvil of the recording industry's overall investment and cost structure on the scale so as to tip it in favor of its confiscatory rate proposal.

175. Here, the evidentiary record as to relative investments, costs, and risk weighs overwhelmingly in favor of the SDARS. *See* SDARS PFF Parts V.F-G. Indeed, there is no evidence of any incremental investment made, cost incurred, or risk assumed by the recording companies in connection with the creation or programming of the SDARS. *See* SDARS PFF Part V.C.3.b.(1). Record companies do not create sound recordings for the SDARS; they create them for sale through other channels – and they give copies (CDs) to the SDARS for free and otherwise solicit airplay on satellite radio because they know the SDARS promote, rather than displace, sales. *See* SDARS PFF ¶ 287.

**a. Capital Investments and Costs**

176. As discussed at length in the their Proposed Findings of Fact, the SDARS have had to make many investments in physical infrastructure, personnel, and programming and are in effect required to operate many different businesses simply to deliver their service to subscribers and grow their subscriber base. *See* SDARS PFF ¶¶ 517-532. The SDARS' capital investments and expenditures total over $11 billion through 2006, and the SDARS expect to spend approximately [[ ]] more during the license term. *See* SDARS PFF ¶¶ 521-523, 573.

177. As part of its effort to turn section 801(b)(1) into a vehicle for subsidizing the recording industry during a transitional phase in its history, SoundExchange attempts to shift to the SDARS the burden of costs that are unrelated to the creation of the copyrightable works being used by the SDARS. SoundExchange first seeks to equate the SDARS investments in the product made available to the public, satellite radio, with the record companies' total investments

in their business of producing, marketing and distributing sound recordings.[22] As the SDARS established in their Proposed Findings of Fact, SoundExchange's evidence concerning costs relating to the manufacture and distribution of physical products, touring, and promotion of artists and sound recordings, SX PFF ¶¶ 975-88, goes beyond the creation of copyrightable works. *See* SDARS PFF ¶¶ 218-22; *see also* 6/26/07 Tr. 35:9-36:3 (Chmelewski). Indeed, Warner Music Group has flatly stated that, "[i]n digital formats, costs related directly to physical products such as manufacturing, distribution, inventory and return costs do not apply," SDARS Ex. 35 at 9, that it "ha[s] a highly variable cost structure, with substantial discretionary spending and minimal capital requirements," SDARS Ex. 35 at 2.

178. In short, SoundExchange's arguments are all beside the point. The fact of the matter is that all of the SDARS' costs and investments go towards the creation of the satellite radio product, and none of the record labels' costs and investments go towards the creation of that product.

**b. Risks**

179. The only risk to itself that SoundExchange has identified is the risk of substitution from satellite radio, *see id.*, an argument that is entirely unsubstantiated. *See* SX PFF ¶¶ 669-72; 999-1003.

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[22] In so doing, SoundExchange states the SDARS have only made $3 billion in total investments since inception, which SoundExchange claims to be far less than that invested by record companies over the past few years. *See* SX PFF ¶ 975. This comparison is flawed because the SDARS' figure – derived from the testimony of Armand Musey – only included investments the SDARS had collectively spent on building their physical infrastructure. *See* SX PFF ¶ 975; Musey WDT ¶ 13. That figure does not count the investments and expenditures the SDARS have made in personnel, programming, and subscriber acquisition, among others. In contrast, SoundExchange cites Warner Music Group's 2006 overall expenditures, which includes everything from discovering talent, to recording costs, to paying for Kid Rock's entourage, rather than its investments, let alone investments in the satellite radio product. *See* SX PFF ¶ 975; SDARS Ex. 35 at 139 (WMG 2006 10-K); *id.* at 7 (listing representative acts).

180. SoundExchange claims that "[b]ecause the satellite radio service is substitutional, its very existence increases the risks faced by the sound recording industry. . . .," SX PFF ¶ 999, but, as shown in the SDARS' Proposed Findings of Fact, there is no credible record evidence of any such substitutional effect. *See* SDARS PFF Parts V.C.4-5. SoundExchange failed to establish any link between the creation of the SDARS and the overall decline in CD sales, which, in fact, commenced before the SDARS launched. *See infra* Part III.B.1 (discussing substitution). To the contrary, its witnesses identified a host of other causes. *See* SDARS PFF ¶¶ 237-41 (record label representatives citing piracy, single track downloads, and the recording industry's own, outdated business model as causing the decline in CD sales); *see also* 8/30/07 Tr. 60:1-62:9 (Herscovici) (acknowledging peer-to-peer downloading, a preference for single track purchases, increased availability of lower priced digital albums, competition from videos and DVDs, and the aging of the U.S. population as possible causes for the decline in CD sales); SDARS Ex. 35 at 21-29, 41-43 (setting out risk factors with no mention of satellite radio); 6/26/07 Tr. 35:9-36:3 (Chmelewski) (admitting that all of his company's risks arise without regard to satellite radio).

181. The record companies' real concern is that future sales of downloaded songs will carry diminished profit margins. *See* Kushner WDT at 4; 6/26/07 Tr. 119:15-120:5 (Kushner) (stating that the problem the record labels face is that they sell very few full-album downloads and people are instead choosing to purchase only the songs they want). However, this is a risk that the record companies are cognizant of and accept as part of their business:

> Any legitimate digital distribution channel that does develop may result in lower or less profitable sales for us than comparable physical sales. In addition, the transition to greater sales through digital channels introduces uncertainty . . . regarding the potential impact of the "unbundling" of the album on our business. . . . [I]t remains unclear how consumer behavior will change when faced with the opportunity to purchase only their favorite tracks from a given album rather than the entire album.

SDARS Ex. 35 at 25.

182. SoundExchange also asks the Judges to take account of the business risks posed to the recording industry as a whole, such as "the shortening of artist careers and the sudden failures of artists that have established track records." *See* SX PFF ¶ 992. Aside from the fact that such purported risks have nothing to do with satellite radio, SoundExchange elsewhere describes how the record companies have resisted lowering their costs by giving such artists smaller advances and spending less on marketing risky albums. *See* SDARS Ex. 35 at 7, 22; Kushner WDT at 18. SoundExchange cannot fairly demand that the recording industry's own failure to mitigate its risks and costs should be factored into the rate the SDARS must pay for the right to perform sound recordings.

183. In any event, the evidence establishes that the record companies have dramatically overstated the risk they face. In its 2006 annual report, Warner Music Group stated that it expects "to generate stable cash flow" into the future because its "revenue base is derived primarily from relatively stable and recurring sources" and that in any given year "less than 10% of [WMG's] total revenues depend on artists without an established track record, with none of these artists typically representing more than 1% of [WMG's] revenues." SDARS Ex. 35 at 1-2 (emphasis added). WMG further claimed that it has "been able to consistently attract, develop and retain successful recording artists" enabling the development of "a large and varied catalog of recorded music . . . that generate[s] stable cash flows." *Id.* at 1; *see also id.* at 2 (touting its ability to sign new artists and to capitalize on its catalog of recordings across a "diverse array of genres").

184. In contrast, the risks the SDARS have faced in bringing the satellite radio product to the public have been immense and are detailed fully in the SDARS' Proposed Findings of Fact. *See* SDARS PFF ¶¶ 622-702. Going forward, the SDARS' major risks are financial

viability and competition with other audio entertainment devices in vehicles and on the store shelves. *See id.* ¶¶ 672, 676, 693-694, 696-698.

185. In sum, the business risks that SoundExchange is seeking to mitigate by imposing an exorbitant sound recording performance fee on the SDARS have nothing to do with the SDARS and therefore are not properly considered under section 801(b)(1)(C). All of the SDARS' risks related directly to the creation of the product at issue, however, and it is therefore clear that the great weight of the risk involved in bringing the satellite radio product to the public is taken by the SDARS.

### D. The Sound Recording Fee Must Minimize Disruption of the Structure of the Industry and on Prevailing Industry Practices

#### 1. Phasing-In SoundExchange's Rate Proposal Would Not Cure Its Disruptive Impact on the Structure of the Industry and on Prevailing Industry Practices.

186. SoundExchange interprets the fourth statutory factor to be satisfied simply by a "phasing-in" of SoundExchange's exorbitant proposed rate increase. *See* SX PFF ¶ 1019. As a preliminary matter, and as discussed in detail in the SDARS Reply Proposed Conclusions of Law, nothing in the statute or the decisions cited by SoundExchange suggests that the disruption factor necessarily is satisfied simply by phasing in a rate. *See* SDARS Reply PCL III.C.

187. SoundExchange's position is particularly untenable here, given the magnitude of the "steps" – particularly the first step – called for in its proposal. It is undisputed that the current sound recording royalty rate paid by the SDARS is in a range of approximately 2%-2.5% of revenues. SDARS PFF ¶¶ 735, 741 (citing evidence). The first "step" in SoundExchange's rate proposal is a leap to a rate of 8% of revenues. Thus, the so-called "phased-in" rate (SX PFF ¶ 1019) represents an immediate trebling or even quadrupling of the sound recording royalty

rate. Given the SDARS' projected revenues for 2007, this would amount to an immediate increase in the SDARS' costs of approximately $119 million.[23]

188. As set forth in the SDARS' Proposed Findings of Fact (¶¶ 783-800), the evidence shows that a rate above approximately 4% of revenues – roughly double the current fee level – is likely to have a disruptive impact on the structure of the SDARS industry and on prevailing industry practices. Because the very first step in SoundExchange's rate proposal doubles the rate level at which the SDARS have demonstrated that disruption is likely to occur, *see id.*, it would have a disruptive impact from the outset.

189. This threatened disruptive impact would be compounded by the further rate increases contemplated by SoundExchange keyed to the SDARS' growing subscriber bases. *See id.* ¶¶ 801-03. As Professor Noll testified, because the rate increases in SoundExchange's rate proposal are based on subscriber growth and apply to all revenue (as opposed to revenue generated only by incremental subscribers), they provide a strong disincentive to add subscribers. *Id.* (citing Professor Noll). The additional disruptive impact SoundExchange's proposed "step-ups" would have on the industry is apparent given that the SDARS have yet to acquire the critical subscriber mass and revenues necessary to overcome their enormous costs. SoundExchange fails to explain how this punitive aspect of its rate proposal comports with the statutory directive to minimize disruption to the structure of the industry and to prevailing industry practices.

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[23] This amount was calculated using the 2007 revenue figures for each of the SDARS in Sean Butson's rebuttal models, *see* Butson WRT Apps. A & B, and comparing the existing sound recording cost as a percentage of revenue of approximately 2% for XM and 2.5% to Sirius to the 8% figure proposed by SoundExchange for 2007.

### 2. SoundExchange Provides a Cramped Interpretation of What Qualifies as Disruption to the Structure of the Industries and to Prevailing Industry Practices.

190. SoundExchange argues that "a royalty rate can have a disruptive impact only if it undermines the long-term viability of either the SDARS or the Record Companies." SX PFF at 385 (some capitalization omitted).[24] As the record shows, this is an overly cramped understanding of disruption. While the parties agree that any rate that threatens the SDARS' viability going forward would be disruptive, disruption to the satellite radio industry and on prevailing industry practices may manifest itself in other ways as well. As Professor Noll explained, a rate would threaten viability and be disruptive to the extent that a company could no longer recover its forward-looking costs. Noll WRT at 72-73; 8/16/07 Tr. 84:2-84:20 (Noll). A rate that did not permit copyright users to recover a reasonable return on start-up investments also would be disruptive because it would remove the incentive to invest. *Id.* 76:8-77:19 (Noll); *see also* 6/13/07 Tr. 210:6-211:11 (Musey). In addition, there is no dispute that a rate that would cause one or both of the SDARS to fundamentally change their business, such as by dramatically cutting back on the use of sound recordings, would be disruptive. Butson WRT at 11; Herscovici WRT ¶¶ 92, 111; 8/16/07 Tr. 72:1-13 (Noll).

191. The SDARS have presented detailed evidence proving that SoundExchange's proposed royalty rate would have a disruptive impact on the structure of the satellite radio industry and on prevailing industry practices under each of these tests. This evidence demonstrates that:

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[24] SoundExchange's interpretation of what qualifies as disruption is not shared by its expert, Dr. Pelcovits, who, at least where the record companies are concerned, testified that an annual loss of $100 million – or one percent of the recording industry's approximate total revenues – would be disruptive. 8/28/07 Tr. 180:22-183:10 (Pelcovits).

- SoundExchange's proposed rates are disruptive on their face, because they would cause the SDARS to incur billions in additional net losses and hundreds of millions in free cash flow losses over the six-year license term while taxing the companies' liquidity to the breaking point. SDARS PFF ¶¶ 742-82.

- SoundExchange's rate proposal would not permit the SDARS to recover their forward-looking costs during the license term. *Id.* ¶¶ 752-58.

- The massive additional losses that would result from the implementation of SoundExchange's proposed rates would grossly inflate the SDARS' accumulated deficits and prevent the SDARS from providing a return to investors during the license term and for many years thereafter. *Id.* ¶¶ 748-51.

- Significant rate increases would lend the SDARS to cut back on the performance of post-1972 sound recordings to mitigate the risk of business failure. *Id.* ¶¶ 796-98.

SoundExchange failed to analyze any of these other indicia of the disruptive impact of its rate proposal.

### 3. SoundExchange Claims Falsely that the Evidence Is "Undisputed" that a Rate of 5% - 6% of Revenue Would Not Be Disruptive.

192. SoundExchange asserts that "the record is undisputed that a royalty rate that starts at between 5 and 6% of the SDARS' revenues has no disruptive impact." SX PFF ¶ 1025 (emphasis added; capitalization in original omitted); *see also id.* ¶ 1025 ("[a]s a threshold matter, the evidence unequivocally establishes that a royalty rate of between 5 and 6% of the SDARS' revenues will not have a disruptive impact."). SoundExchange seeks to buttress this claim by concluding that "the fact that analysts and the SDARS themselves budget for royalties at these levels [*i.e.*, [[ ]]%] says only that rates at these levels cannot possibly be disruptive." *Id.* ¶¶ 1027-1028. These claims are false. Neither the supposedly "undisputed evidence" cited by SoundExchange nor the voluminous evidence omitted from SoundExchange's Proposed Findings of Fact supports the stated propositions.

193. SoundExchange cites Dr. Herscovici's testimony for the proposition that the "SDARS themselves" budget for royalties at the [[ ]]% level. *Id.* This citation is misleading,

however, because Dr. Herscovici actually testified that he understood from the testimony of SDARS witnesses that they budgeted a rate of 4% for the sound recording fee:

> I understand that Mr. Vendetti, XM's CFO, has testified that a royalty rate of 4 percent of total revenue would have no impact on XM's business plan. Similarly, I understand that Sirius budgets using a royalty rate of approximately 4 percent for sound recordings.

Herscovici WRT ¶ 94. Moreover, Sean Butson, a former equity analyst himself, testified that analysts generally believe the SDARS' current total music performance royalties to be at most 7%, with half (*i.e.*, 3.5%) going to the music publishers and the other half to SoundExchange. *See* 6/19/07 Tr. 171:20-173:1 (Butson). *See also* Butson WDT, App. A & B (direct testimony financial projection models showing a rate of 3.5% for the musical work fee and a sound recording fee of 3.5% historically and at the levels set forth in SoundExchange's original rate proposal for the projected license term).[25]

194. SoundExchange's contention that it is undisputed that a rate of [[ ]]% would not be disruptive is also contradicted by the testimony of the SDARS' financial executives, Messrs. Frear and Vendetti, cited by SoundExchange. In the case of Mr. Frear, SoundExchange cites his testimony for the proposition that "Sirius budgeted a sound recording royalty for 2007 in the range of [[ ]]." SX PFF ¶ 1026. *See also* 8/15/07 Tr. 103:15-104:12 (Frear) (derivation of 4.2% budgeted rate). Given that each 1% of revenue increase in the sound recording rate would generate over $100 million in additional expenses for each of the SDARS over the license term, the *sub silentio* effort to transform the cited 4% rate to 5-6% is both consequential and unwarranted. *See* 6/11/07 Tr. 28:19-29:9 (Frear) (each percentage of revenue increase exceeds $100 million): *cf.* 8/15/07 Tr. 64:7-65:3 (Vendetti) (same impact for XM).

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[25] The difference between the historic and projected sound recording rates in Mr. Butson's models can be viewed by clicking on the row marked "Royalties (est.)" in the electronic versions of the models.

Similarly, with respect to Mr. Vendetti's cited testimony, *see* SX PFF ¶ 1026, SoundExchange's only point appears to be that Mr. Vendetti did not specifically say "disruptive" in testifying that if sound recording royalty rates were to increase above 2% to as much as 6% of revenues, the impact on XM's financial condition would become increasingly problematic in terms of meeting its business plan. 6/6/07 Tr. 37:16-38:16 (Vendetti).

195. SoundExchange similarly misleads in its citation to testimony of SDARS experts Mr. Musey and Professor Noll. SoundExchange cites Mr. Musey for the suggestion that analysts "assume that XM and Sirius pay royalties for musical works and sound recordings of approximately 7-8%." SX PFF ¶ 1027 (emphasis added). From this, SoundExchange argues that [[ ]] can be deducted for the musical works, and therefore that analysts "presume a royalty rate for sound recordings of approximately [[ ]]." *Id.* But SoundExchange's own equity analyst expert, Mr. Butson, testified that analysts believe the current sound recording royalty rate to be 3.5% of the SDARS revenues. *See* 6/19/07 Tr. 171:20-173:1 (Butson); Butson WDT, Apps. A & B (line item "Royalties (est.)").

196. SoundExchange also distorts Professor Noll's testimony. According to SoundExchange, "Professor Noll, the SDARS' own economic expert, admits that at a 6% rate, the SDARS would not be any worse off then they currently are." SX PFF ¶ 1027 (citing 8/16/07 Tr. 169:21-170:4, 185:15-186:19 (Noll)). In fact, Professor Noll was responding to a hypothetical question that required him to make an assumption inherent in Dr. Pelcovits' flawed surplus analysis: that the SDARS' physical capital is their only forward looking investment. 8/16/07 Tr. 184:20-187:10 (Noll). Professor Noll made clear that he vehemently disagrees with this assumption. *See id.* at 103:20-109:11 (explaining the inadequacies of Dr. Pelcovits' analysis of forward-looking costs). *See also id.* at 116:8-117:2 (further explaining that his criticisms of

Dr. Pelcovits' Surplus/Shapley analysis were based on Mr. Butson's former, more optimistic, financial forecasts and that an evaluation based on Mr. Butson's later models would result in a royalty rate next to zero); SDARS PFF ¶¶ 752-58, App. C. Thus, SoundExchange's characterization of this testimony as an "admission" is false.

197. Finally, there is voluminous evidence – ignored by SoundExchange – that squarely contradicts SoundExchange's "undisputed" claim that a 5-6% rate would not be disruptive. *See id.* ¶¶ 783-87 (need for both companies to show return) (citing evidence); *id.* at ¶¶ 788-95 (impairment of Sirius' liquidity at a rate above 4%) (citing evidence); *id.* at ¶¶ 796-98 (potential decreased use of sound recordings); *id.* at ¶¶ 799-800 (threat to XM from significant rate increase above current rate).

#### 4. SoundExchange Mischaracterizes Mr. Musey's Testimony by Suggesting that an Unanticipated Rate Increase Will Cause the SDARS' Stocks To Rise from Their Current Levels.

198. SoundExchange incorrectly claims that Mr. Musey "testified that a royalty rate of the sort SoundExchange proposes would result in an increase in the stock price of XM and of Sirius, resulting in a significant increase for investors." SX PFF ¶ 1117. As a preliminary matter, there is no such testimony by Mr. Musey in the record. Indeed, the "hypothetical sound recording royalty rate" of [[ ]] that SoundExchange attributes to Mr. Musey is a SoundExchange invention. As discussed in the preceding section, SoundExchange's claim that investment analysts assume a sound recording rate of [[ ]] in their projection models is belied by, among other facts, its own investment analyst expert's assumption that the current sound recording royalty rate is at most 3.5%. Thus, SoundExchange overreaches when it claims that Mr. Musey's sensitivity analysis assumes a rate 5% higher than the "[[ ]]% range assumed by analysts." *Id.* ¶ 1121. It is only by bootstrapping from this false starting point that SoundExchange is able to contend, also without evidentiary support, that "in view of investment

analysts and the SDARS' own expert witness, a royalty rate of [[ ]] would not in any way be disruptive." *Id.* ¶ 1124.

199. Even if SoundExchange's assumption of the "range assumed by analysts" were correct, SoundExchange's argument still would fail because the analyst consensus target stock prices in Mr. Musey's report are over a year out of date and are no longer an accurate reflection of the SDARS' projected valuation. As Mr. Musey explained, investment analysts derive twelve to eighteen month stock price targets based on financial models that discount projected cash flows to determine a valuation. 6/13/07 Tr. 153:2-10 (Musey) . The analyst projections Mr. Musey relied on are from over a year ago. *See* Musey WDT Ex. 2 (showing that most recent report Mr. Musey relied on was published on October 11, 2006). As SoundExchange has recognized, the companies and industry analysts have revised their projections significantly downward based on slower growth since the filing of written direct testimony in this proceeding. *See* 8/27/07 Tr. 308:14-309:4 (Butson) (testifying that the softness in the SDARS' retails sales caused him to cut millions of subscribers from his original projections for his rebuttal models); *id.* at 14:22-15:7 (Butson) (agreeing that the revenue and subscriber growth projections in his rebuttal models have declined substantially from those in his direct case models). The analyst consensus target prices in Mr. Musey's tables are derived from cash flow projections that have been abandoned by the companies, investment analysts, and Mr. Butson because they are overly optimistic, untenable, and thus, inoperative. Therefore, any analysis of a projected rate structure's disruptive effect on the SDARS using the target prices in Mr. Musey's sensitivity tables is likewise out of date and unreliable.

### 5. SoundExchange also Mischaracterizes the Evidence in Claiming that the SDARS Will Be "Highly Profitable" Under the SoundExchange Rate Proposal.

200. SoundExchange postulates that "[u]nder any scenario presented by any party as realistic, if the Court adopts SoundExchange's rate proposal, XM and Sirius will remain highly profitable over time on any metric." SX PFF ¶ 1057 (emphasis added). This sweeping contention is contradicted by the record evidence.

201. Based on Mr. Butson's projections and as shown in the chart below, SoundExchange's rate proposal will push out the SDARS' first profitable year from 2011 to 2013 in Sirius' case, and to 2015 in XM's case. *See* Butson WRT, Apps. A & B. Moreover, during the license period, SoundExchange's rate proposal would generate over one billion dollars more in losses for each of Sirius and XM as compared to their projected losses with their current sound recording royalty costs.

**PROJECTED NET LOSSES**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Total For Term |
|---|---|---|---|---|---|---|---|
| **At Current Costs** | | | | | | | |
| XM (2% Revenues) | $ (553,446) | $ (423,625) | $ (348,892) | $ (183,439) | $ 12,651 | $ 163,734 | $ (1,333,016) |
| Sirius (2.5% Revenues) | $ (553,285) | $ (398,140) | $ (252,010) | $ (26,491) | $ 179,941 | $ 386,680 | $ (663,303) |
| **At Ceiling of 4%** | | | | | | | |
| XM | $ (575,894) | $ (451,088) | $ (383,574) | $ (225,959) | $ (37,980) | $ 104,918 | $ (1,569,577) |
| Sirius | $ (572,213) | $ (422,959) | $ (284,748) | $ (67,848) | $ 130,096 | $ 328,300 | $ (889,371) |
| **SX's Proposal** | | | | | | | |
| XM | $ (615,503) | $ (525,192) | $ (508,121) | $ (378,502) | $ (263,330) | $ (230,713) | $ (2,521,360) |
| Sirius | $ (609,172) | $ (470,854) | $ (378,433) | $ (223,819) | $ (102,593) | $ (20,710) | $ (1,805,582) |

*Source:* Butson WRT, Apps. A & B.

202. As explained in the SDARS' Proposed Findings of Fact, SoundExchange's proposed rate structure would be devastating to the SDARS' businesses. SoundExchange's attempted gloss – that the SDARS will be highly profitable "over time" (which, according to Mr. Butson, means "some time long after the rate period ends," *see, e.g.,* 8/27/07 Tr. 318:11-321:2, 307:9-309:9 (Butson); *see* ¶¶ 742-782) – does not alter this fundamental reality. Not only

do projections for 2013 and beyond have little value, as even Mr. Butson conceded (*see, e.g.*, 8/27/07 Tr. 313:11-20 (Butson); 6/19/07 Tr. 214:13-215:10 (Butson); *see also* 8/16/07 Tr. 82:17-83:4 (Noll)) equally, they offer little consolation to the SDARS and their investors which would be faced with the devastating impact of the proposed dramatic increase in rates on the SDARS' accumulated deficits, as shown below.

**PROJECTED INCREASES IN ACCUMULATED DEFICITS**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| **At Current Costs** | | | | | | |
| XM (2% Revenues) | $ (4,111,907) | $ (4,535,532) | $ (4,884,424) | $ (5,067,862) | $ (5,055,211) | $ (4,891,477) |
| Sirius (2.5% Revenues) | $ (4,442,892) | $ (4,847,236) | $ (5,107,430) | $ (5,144,260) | $ (4,976,779) | $ (4,604,694) |
| **At Ceiling of 4%** | | | | | | |
| XM | $ (4,111,907) | $ (4,562,995) | $ (4,946,568) | $ (5,172,528) | $ (5,210,508) | $ (5,105,590) |
| Sirius | $ (4,442,892) | $ (4,865,850) | $ (5,150,598) | $ (5,218,446) | $ (5,088,349) | $ (4,760,049) |
| **SX's Proposal** | | | | | | |
| XM | $ (4,111,907) | $ (4,637,099) | $ (5,145,220) | $ (5,523,722) | $ (5,787,052) | $ (6,017,765) |
| Sirius | $ (4,442,892) | $ (4,913,746) | $ (5,292,179) | $ (5,515,999) | $ (5,618,592) | $ (5,639,302) |

*Source*: Butson WRT, Apps. A & B.

203. Under Mr. Butson's projections (which reflect SoundExchange's fee proposal), the SDARS' accumulated deficits would continue to increase throughout the license period. *See* Butson WRT, Apps. A & B. Indeed, Sirius' accumulated deficit would not return to its pre-license term level until 2018 and XM's would not return to its pre-license term level until sometime after 2020. *Id.* Under SoundExchange's rate proposal, then, the SDARS and their investors would not receive a competitive return on investment for decades. *See* SDARS PFF ¶¶ 748-50 (explaining the disruptive effects of failure to provide a competitive return on investments).

204. By contrast, when the SDARS' current sound recording costs are substituted into Mr. Butson's projection models, the SDARS start to repay their investors in 2011. Even with the maximum 4% rate the SDARS could absorb without a disruptive impact on the industry, the SDARS would be able to start reducing their deficits by the end of the license period.

205. SoundExchange acknowledges the critical importance of generating free cash flow. *See* SX PFF ¶ 1099 ("[f]or a company to remain liquid and provide a return to its investors, it is essential that the company generate free cash flow over the longer term"). Yet its proposed rate structure would cause the SDARS to lose hundreds of millions in free cash flow over the course of the license term.

**PROJECTED FREE CASH FLOW LOSSES**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Total For Term |
|---|---|---|---|---|---|---|---|
| **At Current Costs** | | | | | | | |
| XM (2% Revenues) | $ (336,922) | $ (95,503) | $ (9,389) | $ 184,928 | $ 356,965 | $ 520,870 | $ 620,949 |
| Sirius (2.5% Revenues) | $ (376,581) | $ (179,462) | $ 30,715 | $ 228,780 | $ 370,275 | $ 480,957 | $ 554,685 |
| **At Ceiling of 4%** | | | | | | | |
| XM | $ (359,371) | $ (122,645) | $ (43,753) | $ 142,777 | $ 306,744 | $ 462,364 | $ 386,117 |
| Sirius | $ (395,510) | $ (203,597) | $ (1,257) | $ 188,323 | $ 321,278 | $ 423,358 | $ 332,595 |
| **SX's Proposal** | | | | | | | |
| XM | $ (398,979) | $ (193,671) | $ (164,146) | $ (8,038) | $ 87,499 | $ 136,097 | $ (541,238) |
| Sirius | $ (432,468) | $ (250,310) | $ (88,445) | $ 41,418 | $ 99,648 | $ 91,396 | $ (538,761) |

*Source*: Butson WRT, Apps. A & B.

206. As shown in the table above, SoundExchange's rate proposal would decrease the SDARS' free cash flow over the term by nearly $1.8 billion, causing each of the SDARS to lose over $500 million over the course of the license term. *See* Butson WRT, Apps. A & B ("free cash flow" line); *see also* 8/27/07 Tr. 320:3-321:2 (Butson). Even after the free cash flow turns positive in the later years of the license term, the amount generated would not nearly make up for the free cash flow losses incurred in the earlier years. *Id.* In contrast, under both the SDARS' existing cost structures and the maximum 4% rate the SDARS could absorb without risking disruption, Sirius and XM would generate positive cash flows beginning in 2009 and 2010, respectively, and overall positive free cash flow for the entire license period. *See* Butson WRT App. E; 8/27/07 Tr. 321:6-323:6 (Butson) (confirming approximately the same result at a 4% rate in his sensitivity tables).

207. As for SoundExchange's citations to the companies' belief that they can have a profitable future (*see, e.g.*, SX PFF ¶ 1035-54) those expectations are predicated on continued sound recording royalty rates in the lower, rather than in SoundExchange's astonishingly high, end of the spectrum. *See* SDARS PFF ¶¶ 742-82.

### 6. SoundExchange Understates the Harm to Sirius from SoundExchange's Model.

208. As discussed in the SDARS' Proposed Findings of Fact, ¶¶ 759-64, Mr. Butson made various errors in preparing his Sirius model, including the understatement of significant costs. Despite the fact that these inaccuracies were specifically raised during the trial, they are ignored in SoundExchange's Proposed Findings of Fact. Sirius Exhibit 58 provides a more accurate model for Sirius during the upcoming license term.

209. Apart from questioning the use of both company and analyst data in preparing Exhibit 58, the reasons for which are addressed in the SDARS' Proposed Findings of Fact (at 292 n.11), SoundExchange's only specific criticism of Exhibit 58 relates only to whether or not an annual price increase should be incorporated.

> The most significant difference between the Sirius modeling provided by Mr. Frear and Mr. Butson's consensus model concern ARPU, or average revenue per user. The reason for this difference is that Mr. Frear assumed that the price of the SDARS service would decline, in real dollars, throughout the rate term, 8/15/07 Tr. 182:3-7 (Frear), while Mr. Butson assumed that retail rates would increase at the rate of inflation. Frear WRT at 6, SIR Trial Ex. 61; 6/19/07 Tr. 166:21-167:2 (Butson). However, Mr. Frear provided no empirical or economic support for his claim that Sirius would not increase rates at least to keep pace with inflation throughout the rate term. 8/15/07 Tr. 184:10-18 (Frear).

SX PFF ¶ 1073.

210. In fact, although SoundExchange and Mr. Butson suggest that a price increase tracking inflation should be considered automatic, Mr. Butson was forced to concede on cross-

examination that Sirius has not raised its price – to track inflation or otherwise – and therefore that the price of the service consistently has declined in real dollars:

> Q: But Sirius has never raised its price, right?
>
> A: I don't know offhand. They may have in the early days before I covered the companies.
>
> Q: Okay, well, it's been 12.95 the entire time that you've been covering the industry or been looking at the industry, correct?
>
> A: I believe so, yes.
>
> Q: Okay, so every year since the beginning of the point that you're familiar with until now, the price of Sirius has been declining in real terms, right?
>
> A: I suppose that's true, yes.

8/28/07 Tr. 9:12-10:4 (Butson) (emphasis added). Likewise, while both Mr. Butson and SoundExchange vaguely cite "historical" practices in suggesting that annual price increases should be included in a model, it has never specified any such historical practices, and Sirius' history conclusively refutes Mr. Butson's assumption of an annual price increase. *See* SX Trial Ex. 28 at 6 (confirming that "Sirius has kept its monthly price at $12.95 since inception"); *see also* SDARS PFF ¶ 760 (only one XM price increase, with premium content incorporated in base price).

211. SoundExchange also attempts to support its rosy projections with what it claims are internal documents. *See, e.g.,* SX PFF ¶ 1048-53 (citing SX Trial Ex. 77). As an initial matter, SX Trial Exhibit 77 is not an internal document prepared by either company; it was prepared by Morgan Stanley. Moreover, it projects subscriber growth, revenue, and free cash flow far in excess of anything that either company (or even Mr. Butson) now believes is

reasonable. Thus, SoundExchange's attempt to present SX Trial Ex. 77 as a current projection, given all of the testimony to the contrary, is misleading.[26]

### 7. SoundExchange Understates the Harm to XM from SoundExchange's Model.

212. As explained in the SDARS Proposed Findings of Fact (¶¶ 772-82), the projection model offered by SoundExchange in support of its rate proposal understates the disruptive effect it would have on XM because of Mr. Butson's many unreliable assumptions and omissions concerning XM's debt and liquidity. In its Proposed Findings of Fact, SoundExchange glosses over what SoundExchange itself acknowledges as evidence of disruption: XM's need to raise $400 million in additional debt. *See* Butson WRT, App. B. ("balance sheet"); 6/28/07 Tr. 25:13-26:11 (Butson) (acknowledging that he added $400 million to XM's existing debt of $1.5 billion starting in 2008 in order to finance the increase in sound recording fees and avoid going "broke").

213. SoundExchange states that:

> Under SoundExchange's second amended rate proposal and the SDARS' financial condition today, the SDARS would be fully funded. That is, to remain liquid, the SDARS would have only to refinance existing debt as it comes due and, in XM's case, renew lines of credit as they expire, which is customary. They would not have to access the credit markets for additional debt or raise funds by issuing new stock.

SX PFF ¶ 1105. As explained in the SDARS' findings and by Mr. Butson on the witness stand, this is far from a given. To finance SoundExchange's rate proposal, Mr. Butson had to add $400

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[26] SoundExchange also cites what it falsely terms "Sirius XM internal models," which are actually models prepared by Mr. Butson based on internal data. *See* SX PFF ¶¶ 1064-69. However, for Sirius, SoundExchange neglects to mention Mr. Frear's testimony, both in his written rebuttal testimony and at the rebuttal hearing, that these internal documents contained projections that were no longer valid in view of the slowdown in the retail channel and the resulting decision by Sirius management not to implement a price increase. Frear WRT ¶ 9; 8/15/07 Tr. 90:11-91:15 (Frear). Similarly, for XM, the older projections are no longer valid in view of the retail slowdown. *See* Vendetti WRT ¶¶ 3-10.

million in debt to XM's capital structure. *See* Butson WRT, App. B; 6/28/07 Tr. 25:13-26:11 (Butson). Neither SoundExchange nor Mr. Butson offered any proof that XM would be able to raise and sustain this increased level of indebtedness, offering only vague assurances from its experts that "even if the SDARS needed to borrow additional funds . . . they are almost certain to be able to do so." SX PFF ¶ 1105 (citing Herscovici WRT at 39). In contrast, Mark Vendetti, XM's Senior Vice President of Corporate Finance, testified that the mixture of increasing debt and continuing losses presented in SoundExchange's model would create a highly uncertain business climate for XM. *See* 8/15/07 Tr. 45:13-47:18 (Vendetti).

### 8. SoundExchange Makes Misleading Statements Concerning the Effects of Its Rate Proposal on the SDARS' Liquidity.

214. SoundExchange fails to engage in any meaningful analysis of liquidity issues apart from asserting that the SDARS previously have been able to borrow money. *See, e.g.*, SX PFF ¶¶ 1219-27. On closer examination, however, SoundExchange's position falls apart.

215. SoundExchange fails to account for the fact that the SDARS' two most recent financings, Sirius' $250 million term loan and XM's $289 million capital lease, were both secured by physical assets. *See* 8/15/07 Tr. 133:1-134:2 (Frear) (explaining that Sirius' term loan was secured by substantially all of Sirius' physical assets, which Sirius had never had to pledge in the past); 6/05/07 Tr. 307:9-17 (Vendetti) (explaining that to raise the $289 million XM effectively sold its XM-4 satellite and now leases it back). When asked why the SDARS were not able to obtain debt without pledging physical assets, the SDARS' financial expert Armand Musey explained:

> My sense right now is given these companies credit situation [*i.e.*, below investment grade or "junk" credit ratings], the credit markets are very hard and that either was not an option, in other words, people would not lend them money on an unsecured basis now or that the cost would be prohibitively expensive.

6/13/07 Tr. 145:3-9 (Musey). SoundExchange fails to acknowledge the restrictions on the SDARS' most recent debt issues, which were put in place assuming the SDARS' current cost structure and current projected path to profitability (*i.e.*, without the over one billion dollars in additional sound recording royalty expenses advocated by SoundExchange). *See* SX PFF ¶¶ 1219-32.

216. SoundExchange also claims misleadingly that the significant debt faced by both companies poses no threat to their liquidity because "of the total long-term debt figure, all but $126 million comes due in 2009 or later. By approximately that time, both companies will be producing positive free cash flow, meaning that they will be able to finance their business and debt payments with internally generated cash flow." *Id.* ¶ 1225 (emphasis added). SoundExchange's own projection models show this to be false. Mr. Butson projects that Sirius will generate its first positive free cash flows in 2010 – not 2009. Moreover, the amount generated that year, $41 million, would be dwarfed by the amount of debt maturing prior to then. *See* SDARS PFF ¶ 765 (stating that Sirius has $300 million in bonds maturing in 2009). *See* Butson WRT, App. A. In XM's case, SoundExchange projects that it will not generate its first positive cash flows until 2011 at the earliest. *Id.*, App. B. The amount SoundExchange projects will be produced then, $87 million, will be too little and two years too late to finance the $428 million in debt payments XM must make in 2009. *See* SDARS PFF ¶¶ 772-82 (explaining in detail XM's imminent debt maturities).

217. SoundExchange in fact disregards the financial pressures exerted on Sirius and XM by their significant debt maturities in 2009. As explained in the SDARS' Proposed Findings of Fact, the companies face significant bond maturities in 2009: $428 million for XM and $300 million for Sirius. *Id.* ¶¶ 765, 773. The companies' credit ratings are already below investment

grade and any worsening of their credit profiles due to a significant increase in the sound recording rate could jeopardize their abilities to service or refinance their debt obligations. *See, e.g.*, 8/15/07 Tr. 46:4-8 (Vendetti) (stating, in reference to the enormous increase in losses set forth in the SoundExchange projection model, that the "combination of increasing debt with a business that would not have a net income until 2015 would put XM in a situation where I don't believe they would be able to refinance that existing debt"). Because an event of default would create a catastrophic risk for the companies, such as forcing bankruptcy, XM's and Sirius' management teams would attempt all manner of changes to their business models to avoid catastrophe, such as drastically cutting expensive programming, eliminating research and development programs, and terminating distribution agreements. Although these actions may save the satellite radio industry from catastrophe, they will have a disruptive impact on the structure of the industry and on prevailing industry practices.

**9. An Increase in the Sound Recording Rate Exceeding 4% of Revenue Would Be Disruptive to the Structure of the SDARS Businesses and to Prevailing Industry Practices.**

218. In their Proposed Findings, the SDARS demonstrated the threat to liquidity and viability that would be posed by sound recording rates in excess of approximately 4% of revenue, let alone by rates approaching those proposed by SoundExchange. SDARS PFF ¶¶ 783-800, and that even a one percentage point increase in the royalty rate would add over $100 million to each of the SDARS' operating costs. *See id.* ¶ 721. There is no evidence in the record that these increased costs would bring additional programming or be offset by an increase in subscriber additions or by other sources of revenue. Thus, as responsible managers of businesses that are struggling to generate profits and achieve some level of financial stability, XM's and Sirius' management teams would be forced to make cuts in programming content that would significantly disrupt the existing "structure" of the satellite radio industry and "generally

prevailing industry practices." 17 U.S.C. § 801(b)(1)(D). As Mr. Karmazin testified regarding the impact of a higher rate:

> Well, I think it would be unbelievably disruptive for us to do this, but I think what would happen, would be that we would just have to dramatically scale back on the music programming that we offer. And that we would replace the music with content that would not be as easily available anywhere else, and that, though it would be disruptive for us, we would – I would feel at Sirius that I would have to make those changes.

6/6/07 Tr. 311:3-311:12 (Karmazin). *See also* 6/12/07 Tr. 30:21-32:13 (Frear).

219. There is no dispute that a significant change in the SDARS' business model would detrimentally affect consumers and therefore would be "disruptive." *See* SDARS PFF ¶¶ 796-97 (stating that Professor Noll and Sean Butson agree that a change in the quality of the SDARS service would have a disruptive impact on subscribers and would thus qualify as "disruptive" under the statute). In light of the companies' enormous losses to date and imminent and significant debt maturities within the next few years, the management teams of XM and Sirius are under enormous pressure to demonstrate that these services are capable of becoming viable, profitable, companies within a realistically foreseeable timeframe (*i.e.*, within the next three years). *See id.* ¶ 784. To date, XM and Sirius have sought to overcome their enormous cost structures and reach profitability by increasing their subscriber bases by offering diverse and innovative content. However, an increase in the sound recording rate beyond 4% of total revenue (which would represent a doubling of the SDARS' existing royalty costs and generate approximately $850 million in fees for SoundExchange over the license term)[27] would force XM's and Sirius' management teams to choose an alternative path to profitability, potentially dramatically cutting music programming and sports, entertainment, news and talk programming.

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[27] *See* Butson WRT, Apps. A & B (changing the percentage sound recording royalty rate to four percent).

Such cuts surely would constitute a "disruptive" change in the "practices" of the SDARS businesses.

### 10. SoundExchange Cannot Avoid the Disruptive Impact of Its Proposal by Pointing to the Proposed Merger, when Approval, Regulatory Conditions To Be Imposed and the Realization of Synergy Benefits Remain Highly Speculative and Uncertain.

220. In a remarkable assertion, SoundExchange claims that the mere pendency of the hoped-for but unapproved merger of Sirius and XM "effectively takes disruption off the table as an issue." SX PFF at 454 (original capitalization omitted). On the record before the Judges, however, attempting to divine both the prospects of approval of the proposed merger and the terms on which it might be conditioned would require heaping speculation on top of speculation.

221. Contrary to SoundExchange's claims (*e.g., id.* ¶ 1239), there is no reasonable certainty that the merger will be approved. The proposed merger must receive separate approvals from both the Department of Justice and the Federal Communications Commission, neither of which has yet given its approval. 6/7/07 Tr. 32:3-33:20 (Karmazin). The FCC will be required to determine that approval of the merger is in the public interest. *Id.* at 33:1-6. This has been explained by FCC regulators as a "high hurdle [the SDARS] would have to overcome." 8/22/07 Tr. 192:1-4 (Karmazin).

222. Although Sirius and XM believe the merger should be permitted to proceed, an array of powerful interests is aligned against it, including the National Association of Broadcasters, "a very powerful lobbying organization." *Id.* at 192:4-5.

223. Adding further uncertainty, there is also a significant level of congressional interest in (and opposition to) the merger. As Mr. Karmazin noted, "[s]ince we announced the merger, February 19th, I've had four Congressional hearings, . . . we've had 70 plus

[C]ongressmen, a bunch of [S]enators, write letters to the Justice Department and to the FCC saying that the merger should not be allowed to proceed." *Id.* at 191:16-22.

224. Despite the companies' advocacy, the undisputed testimony shows that Wall Street estimates the likelihood of the merger being permitted to proceed as significantly less than 50%, based on the stock prices of the companies since the merger was announced. *Id.* at 192:6-17.

225. In addition to the uncertainty as to whether the proposed merger will be approved at all, there is also substantial uncertainty as to the conditions that might be imposed by regulators as a prerequisite to approval. For example, the companies already have committed to offer lower-priced packages, which could negatively affect ARPU if they were adopted by a large number of customers.

226. While cost savings from the elimination of redundancy would mean that the combined entity would almost certainly be in a stronger position than the two companies currently are – indeed, this was the impetus for the merger – the magnitude and timing of the savings are entirely speculative based on the record.

227. The companies have not directly communicated with each other regarding potential cost savings. 6/6/07 Tr. 349:17-350:6 (Karmazin). What is clear, however, is that any initial savings would be modest and that the major savings (most significantly, from eliminating satellite redundancy) would be many years down the road. As Mr. Parsons testified :

> [I]t is clear that if, in fact, the merger is approved, and if it is able to go forward which is, we still hope will occur, it will likely be in the 2008 timeframe.
>
> Your first year of savings tend to be lost because of the integration cost, paying even severance payments or other things like that to get out of leases or to lay off employees and severance.
>
> And so then you begin bringing in those savings over time. Some of the largest single savings items are the ones that occur with consolidation of the terrestrial

> repeater network into a singular network or changes in the satellite architecture to be able to share a common satellite.
>
> And those tend to occur many years out in the future before you are able to capture those.

6/2/07 Tr. 97:2-21 (Parsons).

228. SoundExchange's expert on the finances of the SDARS, Sean Butson, failed to do any modeling of the finances of the prospective combined entity. 8/27/07 Tr. 273:13-22 (Butson). As he explained:

> [O]f those big points, the only one I haven't modeled is the merger. And the reason for that is that there is not enough good data out there, either provided by analysts or by the companies themselves and, for that matter, or in the materials, the non-public materials, that I reviewed as part of this case. I didn't see anything that was substantial enough, actually, to build a financial model off of.

*Id.* Mr. Butson's testimony belies any contention by SoundExchange that the evidence in the record, including the non-public materials, permits any firm conclusions to be drawn with respect to the finances of a potential merged company, should such a company ever come into existence.

229. In asking the Court to consider the merger in the process of the current ratemaking, SoundExchange is also asking the Court to speculate as to the impact on the SDARS of any conditions that may be imposed by the regulators to secure approval of the merger: price freezes, spectrum givebacks or other actions that could adversely effect the realization of merger synergies.

230. As a final matter, SoundExchange fails to acknowledge the effect of its construction of its rate proposal in connection with the merger. According to Dr. Pelcovits, once the merger were effected and the companies were actually combined, the SoundExchange royalty rate would skyrocket from the current approximately 2%-2.5% of revenues to over 20% of revenues in 2008. *See* 8/28/97 Tr. 221:8-222:8 (Pelcovits); SoundExchange Third Amended

Rate Proposal at 3 (increasing rate to 20% of revenues "for every month after the SDARS has publicly reported that its number of Subscriptions is a number equal to or more than 17 million Subscriptions and less than 19 million Subscriptions" and increasing rate to 23% of revenues "for every month after the SDARS has publicly reported that its number of Subscriptions is a number equal to or more than 19 million Subscriptions") . Using combined 2008 revenues of approximately $2.6 billion as estimated by Mr. Butson as an example, on the event of such a merger and ensuing actual combination, the sound recording royalty would increase from approximately $230 million to approximately $560 million under SoundExchange's proposal for 2008 alone. This extra $330 million in 2008 royalties, which would grow larger in later years, is never acknowledged in SoundExchange's discussion of how the proposed merger "takes disruption off the table ," *See* SX PFF ¶¶ 1233-46 , or how it allows fair income to the SDARS. Nor does SoundExchange justify the resulting additional $1.8 billion over the license term. Such a result would be neither rational nor economically justified and should not be countenanced. Nor would it be consistent with the post merger operation of the SDARS as two distinct operating companies and statutory licensees.

### 11. Mr. Musey's Internal Rate of Return Analysis Demonstrates that the SDARS and, Thus, Their Stockholders, Have Not Received a Competitive Return on Investments.

231. SoundExchange's claim that Mr. Musey's internal rate of return analysis on the common equity invested in the SDARS is not relevant to the Judge's weighing of the fourth statutory factor is wrong. As the SDARS have explained, "[a] rate that did not permit a copyright user to recover a reasonable return on start-up investments would be disruptive because if potential investors knew they will never recover start-up costs such as those required, in the case of the SDARS, to obtain a license, building the system, and developing a marketing strategy, 'there will never be another technology introduced that makes use of sound recordings

involving digital technology.'" SDARS PCL ¶ 103 (citing Noll WRT at 72-73; 8/16/07 Tr. 84:2-84:20 (Noll)). *See* SDARS PFF ¶¶ 748-758 (explaining that SoundExchange's proposal contemplates no return whatsoever on investment, for the license period and many years thereafter, and does not even permit recovery of forward-looking costs).

232. In his written rebuttal testimony, SDARS' expert Armand Musey, a former equity analysts and investment banker, performed an internal rate of return analysis ("IRR Analysis") on only the "aggregate common equity investment for each" XM and Sirius, leaving aside the returns due other substantial investments in the SDARS, such as debt capital and strategic and private equity investments. Musey WDT ¶¶ 21-23. This exercise was based on the basic economic proposition that "if they are not allowed a fair return, investor enthusiasm for investing in common equity will diminish and make it more difficult to finance innovative projects in the future." *Id.* ¶ 22. Mr. Musey calculated the internal rate of return on the SDARS common equity by placing the size and date of each SDARS common equity offering on a timeline and then comparing the issues to the aggregate equity holdings of those investors based on the SDARS' stock prices in October 2006 and the then existing 12- to 18-month stock price targets set by industry analysts. *Id.* ¶ 22.

233. Mr. Musey's analysis demonstrated that based on the stock price data available in October 2006, the common equity investors in the SDARS have not received a risk-adjusted, competitive, return on their investments. *See id.* ¶ 22 (table on page 13). Moreover, Mr. Musey demonstrated that the SDARS' return on common equity is lower than their historical weighted average costs of capital or "WACC," the metric used by the financial community to measure the average return expectation of all investors: debt, common equity, strategic and private investment, and so on. *Id.* ¶ 23. Since common equity holders face the greater financial risks

than other investors, the expected returns required by common equity holders must be much higher than the WACC to provide a risk-adjusted return on investment. *Id.* Mr. Musey concluded that common equity investors in the SDARS as a whole have not yet received an appropriate return on investment for the commensurate risks assumed. *Id.* Indeed, investments in XM's common equity have yielded a negative rate of return based on the stock price in October 2006. *Id.*

234. Mr. Musey's analysis, which was confined to investments in the SDARS' common equity, was buttressed by Professor Noll's rebuttal testimony. As Professor Noll stated, "[t]he break-even profit rate for a SDARS operator includes a competitive return on the paid-in financial investments of SDARS investors since it was initiated." Noll WRT at 23 (emphasis added). Professor Noll later explained that such a result is the expected outcome of the competitive market "[b]ecause no one would ever enter an industry unless they expected in the long run to earn at least the competitive return on investment." 8/16/07 Tr. 100:3-6 (Noll). Thus, setting a rate that will not effectively preclude the SDARS' investors from realizing a competitive return on all investments is critical in order to avoid undermining the incentive to invest in innovative technologies that section 801(b)(1) is designed to protect.

235. Mr. Musey's internal rate of return analysis is probative of the fact that, under the SDARS' existing cost structure, investors in the SDARS common equity have received low to non-existent returns. *See* SDARS PFF Part V.F. Looking only to the return on current and future investments, as SoundExchange urges, "does not address whether investors will ever receive a competitive return on their past investments." Noll WRT at 26. *See also* SX PFF ¶ 436 (claiming that "[o]nly a forward-looking analysis can address the objectives raised by the fourth statutory factor"). Commenting on the confiscatory nature of SoundExchange's rate

proposal, Professor Noll noted that "[i]f the methods used by the SoundExchange experts were replicated in each license determination in the future, the resulting rates would prevent satellite radio services from ever recovering their start-up losses and most of their past investments." Noll WRT at 72-73. *See generally* SDARS PCL Parts IV.C-D.

## IV. SOUNDEXCHANGE VASTLY OVERSTATES THE VALUE OF THE SOUND RECORDINGS AT ISSUE IN THIS CASE.

236. Throughout this proceeding, SoundExchange has vastly overstated the "value" of the sound recordings at issue and has consistently misapplied and misrepresented the data from the experts' surveys and from the SDARS' internal surveys. The "value" proposed by SoundExchange is critical to the benchmarks of Dr. Pelcovits and Professor Ordover, and, thus, goes to the heart of SoundExchange's fee proposal. *See* SDARS PFF ¶ 905.

237. The concepts underpinning SoundExchange's "value of music" conclusions are flawed. First and foremost, SoundExchange casts too wide a net. This proceeding is not about the value of "music" or even "music programming," it is about the value of the right to use certain sound recordings. SoundExchange seeks to amplify the "value" of their sound recording performance rights by relying on – and claiming the right to compensation for – how satellite radio subscribers think about and value "music" generally, without considering how much of that value is contributed by the SDARS or others. SoundExchange is entitled to compensation for the "value" of their input into the equation, namely, certain sound recording rights, as that "value" is determined under the 801(b)(1) factors. SoundExchange is not entitled to compensation for the full "value" that consumers may attribute to "music" or "music programming" in the abstract.

238. Second, SoundExchange and Professor Wind continue to rely on time spent listening as a measure of "value," *see* SX PFF ¶¶ 335, 364, 387, 388, 401, ignoring the plain, common-sense observation that people may listen to music for longer stretches of time but

actually subscribe to satellite radio for entirely different reasons. *See* 06/14/07 Tr. 340:12-341:15 (Wind); 06/05/07 Tr. 186:22-188:12 (Logan). Indeed, to take just one obvious example from a different market, people may choose DirectTV for satellite television because of the NFL packages it offers yet spend only a small amount of their overall viewing time watching the NFL.

239. Third, SoundExchange continually confuses what "values" are relevant to the comparisons it attempts to make. The relevant question is not what the value of music programming is as compared to any single other type of non-music programming, such as sports or talk and entertainment. Yet this is how SoundExchange (and Professor Wind) consistently frame the question in order to inflate the relative value of music. *See* SX PFF ¶¶ 353, 355, 358, 367, 403. As Professor Noll testified, the relevant question is the incremental value of music, SDARS PFF ¶¶ 934-36. For example, if marginal music content were tested, "Howard Stern's contribution to subscriptions would loom very large compared to any music category." Noll WRT at 101 n.35.

240. These fundamental flaws in SoundExchange's approach are exacerbated by SoundExchange's unwillingness to fairly review the data in the record. SoundExchange repeatedly mischaracterizes and misuses Professor Hauser's findings. SoundExchange also, in what can only be construed as a deliberate intent to mislead, presents select data – and on occasion unreliable data – from the SDARS' internal surveys to "corroborate" its arguments.

241. The SDARS will not respond herein to every specific misstatement in SoundExchange's Proposed Findings, but a few of the more egregious errors require correction.

### A. SoundExchange Fails To Address the Flaws in the Wind Survey that Were Identified by Professor Hauser and Professor Noll.

242. SoundExchange's main vehicle for its measurement of "value of music" is Professor Wind's survey. SoundExchange's recitation of the Wind survey and its results, *see* SX

PFF ¶¶ 339-69, is essentially a rehash of Professor Wind's direct testimony. Professor Wind's survey is methodologically flawed, was improperly conducted, and is uninformative for all of the reasons demonstrated at trial and as set forth in the SDARS' Proposed Findings. *See* SDARS PFF ¶¶ 905-49. Those reasons will not be repeated here.

243. Tellingly, SoundExchange does not refute the two major flaws of the Wind survey identified by Professor Hauser's – the "tires-on-the-car" and "voice-of-counsel" flaws – opting instead for criticizing Professor Hauser's surveys, which were performed solely to illustrate the effect of those flaws.

244. Notably, in its Proposed Findings, SoundExchange acknowledges some of these flaws, but ignores their clear implication, often reaching affirmative conclusions that are flatly contradicted by the results of Professor Wind's own survey. For example:

- The Wind survey shows that a full 57% of subscribers would not cancel their satellite radio subscriptions even if there were no music available at all on the Services, *see* SX PFF ¶ 361 and Wind WDT at 24, yet SoundExchange continues to argue that music is more than half the value of satellite radio to consumers.

- The results from the only non-leading open-ended question in the Wind Survey (Question 1) show that, when asked why they subscribed to satellite radio, only 17% of subscribers mentioned music as their first response and only 36% of subscribers even mentioned music at all (let alone stated that music was the sole or even most important reason for subscribing). *See* Wind WDT at 29; SX PFF ¶ 353. This result is entirely inconsistent with both the assertion that music constitutes more than half the value of satellite radio and with SoundExchange's assertion that "these open ended questions unambiguously establish music programming as the feature most responsible for causing consumers to subscribe . . . to satellite radio." SX PFF ¶ 355.

245. Likewise, SoundExchange's responses to certain of Professor Hauser's other points are unconvincing. Again, SoundExchange elects to focus on isolated comparisons of "music" generally versus some individual type of non-music programming, or, in other instances, to make comparisons that ignore all other features of satellite radio. *See* SX PFF ¶¶ 403, 410, 414. For the reasons previously discussed, these comparisons are improper and

ignore all of the contributions to "music programming" made by the SDARS. *See* SDARS PFF Part V.D, ¶¶ 919-24.

246. SoundExchange fails to address Professor Noll's criticism that the "all or nothing" choice for music content is a flawed design because the pertinent question is the incremental value of music, and Professor Wind's approach overstates the value of music relative to other content. SDARS PFF ¶¶ 934-36.

### B. SoundExchange's Attacks on Professor Hauser's Approach Are Without Merit and His Surveys Remain the More Reliable Source Regarding the Value of the Sound Recordings at Issue in this Case.

247. The testimony and surveys of Professor Hauser establish that the value of sound recordings at issue in this case is much lower than that proposed by SoundExchange. Professor Hauser's criticisms of Professor Wind's methodology and findings, as well as a discussion of the surveys conducted by Professor Hauser and his conclusions are found in Professor Hauser's written rebuttal testimony and the SDARS' Proposed Findings. *See* Hauser WRT; SDARS PFF ¶¶ 905-49.

248. Although SoundExchange devotes the majority of its response to Professor Hauser's testimony to critiquing Professor Hauser's surveys, it must be remembered that Professor Hauser's extensive testimony critiquing Professor Wind's methodology and results was not in any way dependant on his surveys. Rather, as Professor Hauser explained, the surveys simply illustrated the effect of correcting some of the flaws in the Wind survey. *See* Hauser WRT ¶ 14.

#### 1. SoundExchange's Critiques of Professor Hauser's Surveys Are Unfounded.

249. SoundExchange's critiques, which primarily involve Professor Hauser's "willingness-to-pay" question, are unconvincing. Perhaps most egregiously, SoundExchange

repeatedly states that "[Professor] Hauser reports that consumers are willing to pay $3.33 for a satellite radio service that lacked music." *See* SX PFF ¶¶ 410, 411, 415. SoundExchange takes this figure from the results of Professor Hauser's mall intercept survey, but this value reflects only the instance in which music was removed first and consumers were asked what they would pay for the service. Professor Hauser criticized the use of any value drawn from removing a feature first (without the context of removing other features), and demonstrated that this approach, which was used in the Wind survey methodology, is flawed. Professor Hauser in no way suggested that this result was an accurate measure of any value; to the contrary, he explained in great detail that the figure resulting from removing music first was exaggerated because of the "tires-on-the-car" flaw. *See* Hauser WRT ¶¶ 23-29; 8/21/07 Tr. 116:19-121:19 (Hauser). As the Judges will recall, Professor Hauser corrected this methodological flaw in the Wind Survey by removing features in random order, then averaging the results. *See* Hauser WRT ¶¶ 23-29; 8/21/07 Tr. 124:22-126:3, 150:7-11 (Hauser); SDARS PFF ¶¶ 928-30. SoundExchange's use of the result from Professor Hauser's survey when music programming was removed first to attempt to show that Professor Hauser's survey purportedly was consistent with Professor Wind's is misleading and deceptive. This was not at all what Professor Hauser's survey showed, and he testified to exactly the opposite.

250. Likewise, SoundExchange's "interdependency" argument is unavailing. The argument that most of the features tested by Professor Hauser in his surveys rely on "music" is flawed in that the features stand alone in terms of testing their importance. Respondents who chose "The artist and song title are displayed on my screen" as their most valued feature were clearly doing so in favor of "I can hear music from the 70's, 80's and 90's and today," which was an option also available to them. The selection, however, defines that individual's choice as

what is most important to them about the satellite radio music programming service. Taking SoundExchange's illogical argument – that one cannot have any music programming features without music – a step further, no programming content would have any value without the transmission of the content through the SDARS' technology infrastructure. By SoundExchange's reasoning, the SDARS should be entitled to the value of all programming content as it directly hinges on that contribution of the SDARS to the overall service.

251. Expanding on this concept, SoundExchange uses an example that a consumer may respond that he would pay $0 for a service that had only FM-quality sound or was only available locally. SoundExchange claims that such a response would artificially attribute a value of $12.95 to CD-quality sound or national reception and nothing to "music," which SoundExchange argues drives the value of sound quality and reception. *See* SX PFF ¶¶ 416-17. But this hypothetical consumer may very well find satellite radio valueless if it did not offer CD-quality sound or national reception, and the sound recording rights at issue in this case add nothing in that consumer's view without those key features. That consumer would rather listen to free FM radio than pay anything for satellite radio without CD-quality sound or national reception. Accordingly, a $0 value for "music" in that situation is exactly correct, as is attributing the full $12.95 to sound quality or national reception.

252. SoundExchange also attempts to take credit for every feature tested in Professor Hauser's "anchored importance" question (from his mall survey) that has any potential relation to music. SX PFF ¶ 420. SoundExchange suggests it should be given credit for such broad-based features as:

- "I can always find what I want to listen to, when I want it"
- "Provides excellent sound quality"
- "I can listen to my stations wherever I go, even when traveling long distances"

- "Provides consistently clear reception no matter where I go, even in the city"
- "I can listen to a lot of programs and content not available on either AM or FM radio"
- "It's easy to find what I want to listen to without hunting around"
- "I don't hear the same things over and over"
- "The organization of channels makes it easy for me to explore a specific genre"
- "I can listen to the same stations in the car, at home, or on the Internet"
- "I can listen to uncensored programs"
- "There are shows dedicated to specific topics that interest me"
- "There are stations available for everyone in my family"

*Id.* This defies logic. Most of these features apply equally, if not more so, to all types of programming. To the extent they apply to music generally, they have nothing to do with sound recording rights. To credit the value of these features to SoundExchange makes no sense.

253. SoundExchange's critique of Professor Hauser's Internet survey suffers from the same flaws. SoundExchange again tries to take credit for such features as "the artist and song title are displayed on my screen." *See* SX PFF ¶ 425-26. This critique is based on the same flawed premise that SoundExchange is entitled to compensation for everything even slightly related to music. This is simply not the case.

### 2. Professor Hauser Did Not Misunderstand the Economists' Use of Professor Wind's Results.

254. SoundExchange also attempts to argue that Professor Hauser's corrections to Professor Wind's results were not necessary given the use that Professor Ordover and Dr. Pelcovits made of Professor Wind's "willingness-to-pay" result. This is based on the faulty premise that, because the benchmarks and Howard Stern contracts referenced by Professor Ordover and Dr. Pelcovits, respectively, already took into consideration "functionality" other

than content, further adjustments for that functionality, *i.e.*, all of the features offered by the SDARS included in Professor Hauser's surveys, need not be made. *See* SX PFF ¶¶ 399-400. This argument fails because, as discussed further below, the features tested by Professor Hauser were designed to further examine the value of sound recordings, not replicate the benchmarks used by SoundExchange's economists.

255. Dr. Pelcovits' Stern Analysis: The various features considered by Professor Hauser in his "willingness-to-pay" analysis were designed to test the importance of various consumer identified aspects of music programming, not that of talk programming. Specifically, Professor Hauser considered "commercial free" and CD-quality sound in his mall intercept survey, both of which are unrelated to the value of talk and entertainment programming such as Howard Stern (which includes commercials). Similarly, Professor Hauser designed the Internet survey to measure only the key features of music programming, such as: "commercial free," "selection and sequencing of the songs," "uncensored" music, "live" performances, and "DJ" and "celebrity" personalities. Only one of these features overlaps both talk programming such as Howard Stern and music programming: national reception. Thus, incorporating Professor Hauser's findings into Dr. Pelcovits' Stern analysis is appropriate because only one of the features measured by Professor Hauser was arguably taken into account in Howard Stern's contract.

256. Professor Ordover's Benchmarks: A similar argument can be made with respect to Professor Ordover's benchmark contracts. Those benchmarks were not satellite radio benchmarks, but Internet-based music provider benchmarks. Thus, although they may have been commercial-free, and some may have offered uncensored music, they did not offer national reception or any of the other features tested in Professor Hauser's Internet survey (DJs and

celebrity hosts, selection and sequencing of songs, live music, etc.). Accordingly, using Professor Hauser's survey results to account for these features in determining the value of the sound recording rights at issue was entirely appropriate in this context as well.

### C. When Read Fairly, the SDARS' Internal Consumer Surveys Contradict Rather Than "Corroborate" SoundExchange's Proposed "Value of Music"

257. SoundExchange's effort to bolster Professor Wind's erroneous conclusions with the SDARS' internal surveys is possible only by taking data out of context and completely ignoring important findings of that research. Professor Wind admitted that he only reviewed and discussed those documents selected by SoundExchange's counsel and made no attempt to assess their validity. 6/18/07 Tr. 30:8-31:2 (Wind); Wind AWDT at 5. Fairly read, these studies provide no support for SoundExchange's claim that "music" – or, more appropriately, sound recordings – have more value than all of the other aspects of the SDARS' services.

258. SoundExchange bases its reliance on several cherry-picked numbers from the SDARS' internal survey data in four areas it describes as draw (*i.e.*, obtaining subscribers), willingness to cancel, usage (*i.e.*, listening) and the impact of Howard Stern. In presenting its arguments, SoundExchange completely ignores other survey evidence in each of these areas that undercuts its proposed findings and mischaracterizes the data on which it does rely.

#### 1. "Draw"

259. With respect to subscriber draw, SoundExchange has ignored perhaps the most telling evidence available. In its 2006 Listener Study, Sirius used an open-ended question – the type preferred by Professor Wind – to ask 25,702 respondents for a single answer to the question "[w]hat was your PRIMARY reason you subscribed to SIRIUS?" SIR Ex. 23 at 28 (question 31A). As tallied by the survey vendor TSN, only [[ ]] of the respondents indicated that music was the primary reason they chose to subscribe, while [[ ]] indicated that their primary

reason for subscribing was Howard Stern. SX Trial Ex. 52, SX Ex. 112 DR at 23 (SIR00025629). Moreover, a separate tally of the responses performed by Sirius' programming department also set out in the report actually revealed an even greater disparity:

| Primary Reason for Subscribing | % of Total Responses |
|---|---|
| [[ | |
| | |
| | |
| | |
| | |
| | |
| | ]] |

*Id.* at 24 (SIR00025630). These results show that Sirius' non-music programming is [[ ]] more important to drawing subscribers than its music programming. *Id.*

260. Rather than relying on this data, SoundExchange focuses on less compelling data from Sirius' second quarter 2006 CSAT. SX PFF ¶¶ 374-77. However, the June 2006 Listener Study had a substantially larger survey pool of 25,702 subscribers compared to the overall pool of 2,249 subscribers surveyed in the June 2006 CSAT. Moreover, the data from the CSAT selectively presented by SoundExchange isolates an even smaller sample of just 96 respondents, which is a mere 4% of the June 2006 CSAT total subscriber pool and 0.4% of the June 2006 Listener Study subscriber pool.

261. Additionally, the results reported by SoundExchange from the June 2006 CSAT are from questions that allowed the respondent to provide multiple reasons, not just the "primary" reason, as in the Listener Study. SoundExchange seemingly ignores this fact and inflates the "music" numbers it reports by "netting" the percentage of mentions of music programming and commercial-free music. SX PFF ¶ 394 n.15. SoundExchange, for example,

states that Sirius' CSAT indicates that "[[ ]] of subscribers who joined in June 2006 . . . cited music programming or commercial free music . . . as a reason for being interested in satellite radio." SX PFF ¶ 374. That number appears nowhere in the CSAT. Instead, the study indicates that [[ ]] of the respondents mentioned music programming and [[ ]] mentioned commercial free music. SX Trial Ex. 35 at 17. Given that respondents could mention more than one aspect in response to this question, there could have been substantial overlap in the number of respondents who listed these two different aspects. *See* 6/11/07 Tr. 199:9-201:13 (Heye); 6/7/07 Tr. 285:6-286:12 (Coleman). Aside from the fact that these categories incorporate values separate from the value of the sound recording, SoundExchange does not explain how it "netted" these separate categories.

262. When the more reliable set of responses for the total population surveyed in the June 2006 CSAT are considered, the overall numbers refute SoundExchange's arguments. Across all of the 2,249 subscribers surveyed in the June 2006 CSAT, the responses to the question probing all reasons for interest in satellite radio were as follows:

| **Reason** | **Percent of Respondents Who Listed in Top Three** |
|---|---|
| Talk Programming | [[ ]] |
| Sports Programming | [[ ]] |
| News Programming | [[ ]] |
| **Total Non-Music Programming** | [[ ]] |
| **Total Music Programming** | [[ ]] |

SX Trial Ex. 35 at 17. Thus, contrary to SoundExchange's claims, subscribers mentioned non-music programming twice as many times as music programming when asked about reasons they were interested in satellite radio.

263. Finally, SoundExchange relies on a single internal Sirius email for the proposition that the NFL does not draw subscribers. However, the email makes clear that the NFL "works to establish us as a preferred brand, and overcome any disadvantage we have at retail . . . . And it certainly gave us great credibility with all our OEM and retail partners." SX Trial Ex. 29 at 1. (emphasis added). Without OEM and retail credibility, Sirius would have obtained very few additional subscribers, regardless of its content. 8/22/07 Tr. 148:13-150:10 (Karmazin).

264. SoundExchange similarly mischaracterizes the XM documents, citing most often to a document (SX Trial Ex. 52 at SX Ex. 125 DR at XMCRB 0016479) that states that: "Nearly three quarters of our subscribers (71%) are here for music." SX PFF ¶ 335 and Figure 2. SoundExchange even goes so far as to cite the above quote in the first paragraph of its filing. However, as is obvious from the face of the document itself, the above quote pertains solely to an analysis of "XM Listenership," *i.e.* time spent listening. The data referred to shows no link between time spent listening and reasons for subscribing. To the extent the quoted language is being read by SoundExchange to suggest otherwise, it is simply unfounded.

265. With respect to the "XM Satellite Radio Customer Satisfaction Study," SoundExchange cites this study in an attempt to show that music programming is important to consumers. *See* SX PFF ¶¶ 378, 381 (citing to SX Trial Ex. 2). SoundExchange ignores the fact that when the study asked consumers the reason for their satisfaction ratings, only 10% indicated it was because they "like the music" and only 8% cited the "variety of music," whereas 16% cited "no commercials," and 17% cited issues related to "coverage and reception." SX Trial Ex. 1 at XMCRB 00058050. Similarly, when asked why they initially subscribed, after-market purchasers cited "for the music" only 4% of the time and "for the variety of music" only 4% of the time, numbers only equal to "for Opie & Anthony" (4%) and NASCAR (4%), and less than

"no commercials" (6%), "baseball" (5%), "coverage and reception" (11%), "liked the receiver" (6%), and "cost" (5%). *Id.* at 58052.

266. SoundExchange also relies on a document entitled "XM Corporate Strategy/Planning Meeting" to show the amount of bandwidth XM devotes to music. *See* SX PFF ¶ 379 (citing to SX Trial Ex. 2). The amount of bandwidth is irrelevant to the issue of value. The fact that XM carries a larger number of channels devoted to music simply reflects that other types of programming do not require the same diversity and selection in order to be appealing. This document suggests nothing about the types of programming that draws subscribers. SX Trial Ex. 2.

267. Finally, SoundExchange cites an "XM Satellite Radio Messaging Study" for the proposition that "commercial free music is the most appealing theme." *See* SX PFF ¶ 380. SoundExchange ignores that this message, and the themes suggested in the document, focus on "commercial free," not on music generally. SX Trial Ex. 17 at XMCRB 00051353. In addition, the primary recommendation for "messages" was "100% money back guarantee," not music-related. *Id.* at 00051355. Moreover, the tag lines recommended do not focus on music at all. *Id.* at 00051354. Again, this survey provides no probative information on what draws subscribers.

**2. Willingness to Cancel**

268. In support of the argument that subscribers would be more likely to cancel if the SDARS did not have music programming, SoundExchange cites only to an August 2005 survey performed by Sirius that sought to determine the impact of not renewing a content deal with Fox News. SX PFF ¶ 382. Despite SoundExchange's reliance on this data, its own expert disavowed it: Professor Wind acknowledged that the cancellation data was speculative without a follow-up study, that the two-year old data from this survey were outdated and that a more recent Sirius

survey had attempted to measure willingness to cancel. 6/18/07 Tr. 33:16-35:1, 85:19-87:19 (Wind); *see also* 6/7/07 Tr. 303:4-305:3 (Coleman).

269. Tellingly, SoundExchange and Professor Wind do not present the far more recent and relevant willingness to cancel data from Sirius' June 2006 Listener Study. Those data overwhelmingly establish that news, talk, sports and entertainment channels would be more important to a subscriber's decision to cancel his or her service. For example, [[ ]] channels for which subscribers indicated they would cancel their subscription if dropped were non-music channels. SIR Ex. 22 at 59; 6/7/07 Tr. 302:7-303:3 (Coleman); 6/11/07 Tr. 226:4-21 (Heye). [[ ]]. *Id.* In stark contrast to SoundExchange's misleading presentation of outdated cancellation data, [[ ]] of respondents who had listened to Howard 100 and [[ ]] of respondents who had listened to Howard 101, indicated they would cancel if those channels were dropped; [[ ]] said they would cancel if SIRIUS NFL Radio was dropped, even though the NFL was not even in season at the time of the survey. SIR Ex. 22 at 59. These data reveal that "music" does not have the value to the SDARS that SoundExchange asserts.

**3. Usage**

270. With respect to "usage" survey data, that data is not probative of value in any respect. As Professor Noll opined:

> [T]he fraction of time spent listening to music on satellite radio is not a good measure of the incremental monetary value of a channel. The economics of broadcasting has long emphasized that listening patterns are a poor indicator of value because, once a listener has a receiver, the incremental cost of switching from channel to channel is zero . . . In the case of music, the use of audience shares overstates the incremental value of music on satellite radio to its subscribers.

Noll WRT at 71 (emphasis added); *see also* 6/12/07 Tr. 284:6-20 (Woodbury).

271. For this reason, the SDARS do not consider channel listenership a measure for determining what programming attracts subscribers but instead rely on other measures that show passion for a channel, such as satisfaction, evangelism, and willingness to cancel. *See* 6/7/07 Tr. 290:1-9, 300:15-301:3 (Coleman). For these measures, the survey evidence indicates that non-music content is much more valuable to the SDARS:

- Satisfaction: Non music channels comprise [[ ]];
- Evangelism: Non-music channels comprise [[ ]]; and
- Willingness to cancel: Non-music channels comprise [[ ]].

*See* SIR Ex. 22 (June 2006 Listener Study) at 50-61; 6/11/07 Tr. 214:9-226:21 (Heye) (same).

272. Finally, the fact that Sirius' Listener Study indicates that longtime subscribers (a year or more as of June 2006) reported more listening to music – based on recall of five minutes in the past week not total time spent listening – is not surprising. The bulk of Sirius' most compelling non-music content – Howard Stern, Martha Stewart, NASCAR, etc. – was launched after June 2005. Moreover, given the limited sports programming available when this survey was fielded in June 2006, the reported past week sports programming listening would understate the value of that programming for the same reasons Mr. Cohen indicated the 2006 CSAT did not provide a fair indication of the popularity of sports programming. 6/11/07 Tr. 35:22-36:16 (Cohen); *id.* at 20:16-21:1. In any event, the listening of more recent subscribers is a more important measure than that of longtime subscribers, given the growth of Sirius subscribers since the latter half of 2005. *See* Karmazin WRT ¶ 25 (indicating approximately 1.5 millions subscribers as of April 18, 2005 and 6.58 million as of March 31, 2007).

### 4. The Effect of Howard Stern

273. In attempting to downplay the importance of Howard Stern as compared to music programming, SoundExchange and Professor Wind cite to several pieces of isolated data, which SoundExchange substantially mischaracterizes. The data from Sirius' 2006 Listener Study resoundingly establish the importance of Howard Stern's two channels:

| Data Point | Percentage and Rank of Howard Stern's Channels |
|---|---|
| Primary Reason for Subscribing | [[ ]] |
| Satisfaction | [[ ]] |
| Evangelism | [[ ]] |
| Willingness to Cancel if Gone | [[ ]] |
| Listened to in Past Week | [[ ]] |
| Listened to Frequently | [[ ]] |

SX Trial Ex. 52; SX Ex. 112 DR at 24 (SIR00025630); SIR Ex. 22 at 38, 46, 51, 55, 59.

274. Moreover, as with other measures, SoundExchange again attempts to rely on a subsample of [[ ]] subscribers from the June 2006 CSAT and "nets" responses for music programming and commercial free music. SX PFF ¶ 394. As discussed, above, this approach mischaracterizes the responses and their import and distorts the true impact of Howard Stern. What the survey actually reports is that, for all subscribers surveyed, [[ ]] mentioned Howard Stern as a reason they were interested in satellite radio, as opposed to [[ ]] who mentioned music programming. SX Trial Ex. 35 at 17.

275. SoundExchange also cites an August 2004 Odyssey study indicating that "[[ ]] of radio listeners would be more likely to buy/subscribe if Howard Stern were only available through satellite radio." SX PFF ¶ 392 (citing SX Trial Ex. 83). That study, however, used the total radio listening population of [[ ]] listeners as the baseline. SX Trial Ex. 83 at

SIR00023208. Obtaining [[ ]] of radio listeners as subscribers by adding Howard Stern would have meant adding [[ ]] new subscribers. And of Howard Stern's [[ ]] fans, the Odyssey study indicated that [[ ]] would be more likely to subscribe if Howard Stern were only available on satellite radio. *Id.* at SIR00023233.

## V. THE SOUNDEXCHANGE FEE MODELS RELY ON INAPPLICABLE BENCHMARKS AND MISAPPLIED ECONOMIC THEORY, IGNORE FUNDAMENTAL DIFFERENCES, AND, IF ANYTHING, SUPPORT THE SDARS' FEE PROPOSAL.

### A. SoundExchange's Non-Music Programming and Stern Benchmarks Share Numerous Flaws that Lead to Grossly Overstated Results.

276. SoundExchange advances two fee models based on programming expenditures by the SDARS for non-music programming. In its original written direct statement, SoundExchange argued that the compensation paid to Howard Stern by Sirius provided a reasonable measure of the value the SDARS placed on programming. The evidence presented by Sirius in its written direct statement demonstrated the extraordinarily grave circumstances facing Sirius when it made the Stern deal and the enormous value the deal provided beyond the value of the licensed content. In short, the Stern agreement was an outlier. In his amended direct testimony, Dr. Pelcovits then presented a new fee model based on the total non-music programming expenditures by the SDARS, excluding the Stern outlier.

277. As the SDARS' demonstrated in their Proposed Findings of Fact, the Stern and non-music programming benchmarks do not meet Dr. Pelcovits' or any of the other economists' criteria for a valid benchmark. *See* SDARS PFF Parts VII.D & E.

278. SoundExchange's reliance on these models is ironic given its criticisms of the SDARS' reference to the amounts they pay for musical works as a benchmark. *See* SX PFF ¶¶ 5, 1291-1295, 1377-1409. The musical works performance right and the sound recording performance right, which are complementary rights that generate precisely the same value to the

SDARS and their subscribers, are far more comparable than the sound recording performance right is to Howard Stern or to the NFL, Major League Baseball, Oprah Winfrey, or Martha Stewart.

279. In addition, SoundExchange's two non-music programming fee models suffer from numerous common flaws as well as from flaws specific to each. Part V.A. of the SDARS Reply Proposed Findings of Fact addresses the common flaws in these fee models. Part V.B. addresses the flaws specific to the non-music programming model. Part V.C. address the flaws specific to the Stern benchmark.

### 1. SoundExchange Does Not Even Attempt To Justify Its Use of an Inapplicable Economic Theory.

280. The central theory underlying Dr. Pelcovits' Stern and non-music programming benchmarks is that the amount an SDARS pays for one type of content "on a per-customer-acquired basis ought to equal the amount [the SDARS] would pay for sound recordings on a per-customer-acquired basis." Pelcovits WDT at 10. As Dr. Pelcovits argues, in more technical terms, "[t]he ratio of marginal products to prices should be the same across substitute inputs." *Id.* The SDARS' goal, he argues is "to get the most revenue for its content expenditures." *Id.* As the economics text relied upon by Dr. Pelcovits for his proposition makes clear, the focus of the analysis is the producer's cost, in other words "how to choose a combination of inputs to minimize the cost of producing a given quantity of output." SDARS Ex. 66 at 268, 272 (Besanko & Braeutigam, Subchapter 7.2).

281. Dr. Pelcovits then argues that "[t]he total costs to the SDARS for their music channels (including the sound recording royalty, the publishers' royalty, and the SDARS internal programming expenses) ought to comprise at least the same percent of revenues as the comparable payments for non-music channels." Pelcovits AWDT at 9. In other words,

Dr. Pelcovits argues that the SDARS should be willing to incur the same costs for music programming as they incur for non-music programming. *Id.*

282. First, as demonstrated by the SDARS in their Proposed Findings, Dr. Pelcovits has mis-applied a theory for determining the cost-minimizing mix of inputs, given the prices of those inputs (SDARS PFF ¶¶ 1093) to the very different question of what the input prices should be. SoundExchange does not even attempt to address this basic flaw in its Proposed Findings of Fact.

283. Second, even viewed on its own terms, it is clear that the focus of the theory on which SoundExchange relies is on the costs to the producer of different types of programming. Logic and economic theory dictate that, in considering the cost to a party of entering into an agreement to obtain subscribers, it is necessary to consider the incremental net benefit to the buyer from the agreement, that is, to compare the overall net result to the buyer from not entering into the agreement with the overall net result to the buyer from entering into the agreement.

284. SoundExchange confounds its discussion of its non-music programming models by sliding continuously between the cost of the content agreements to the SDARS and the revenue obtained by the content provider. Those are not the same. The distinction is particularly acute, and particularly important, in connection with advertising revenues, which provide benefits to both the SDARS operator and, potentially, the content provider, without imposing a further incremental cost on the SDARS operator. It is undisputed that advertising revenue is earned by the SDARS on their non-music programming, but is not, as a matter of business reality, available from the SDARS' music programming.

### 2. SoundExchange Fails To Apply Its Economic Theory on Its Own Terms by Ignoring Valuable Rights and Benefits Obtained by the SDARS from Their Non-Music Programming Agreements.

285. To properly consider the costs and benefits of payments for different programming inputs, it is essential to account for all of the incremental costs and benefits to the SDARS from those agreements. The offsetting benefit from advertising revenues is discussed in Parts V.B and V.C., below. But advertising revenues are not the only benefits that SoundExchange ignores in its non-music programming models.

286. Specifically, SoundExchange's models do not consider the rights and benefits of the non-music programming agreements to the SDARS with respect to: (i) the right to advertise and promote the service using the content provider's trademarks, including the right to associate the service with the content provider's brand; (ii) the direct endorsement of the service and active promotion of the service by the content provider; and (iii) immediate news and publicity impact generated by the non-music content deals. The existence of these benefits is undisputed and was established by numerous fact witnesses, by the terms of the agreements themselves, and by expert witnesses. Although SoundExchange quibbles over the valuation of these benefits by the SDARS' expert witnesses, SoundExchange's models ignore them entirely.

287. In addition, SoundExchange fails in its attempt to show that there is no meaningful, and valuable, difference in exclusivity between the sound recording licenses at issue in this case and the non-music content agreements.

288. As Mr. Karmazin testified: "More rights gets you more money. Less rights gets you less money." 8/22/07 Tr. 176:2-4 (Karmazin). SoundExchange's total failure to account for the value of these additional rights and benefits leaves it with an apples-to-oranges comparison that offers no insight into the value of the sound recording performance rights at issue.

### a. SoundExchange Fails To Account for Real Differences in the Exclusivity Provided by the Non-Music Content Agreements.

289. SoundExchange does not dispute (nor could it from a clear record) that the amounts the SDARS were willing to pay to enter into deals with a range of non-music talk/sports/news/entertainment content providers that confer varying degrees of exclusivity, grew out of their recognition that simply playing sound recordings – even as enhanced by the SDARS' programming contributions – was not enough to make satellite radio a commercial success. *See* SDARS PFF ¶¶ 66-68, 321-322; 6/5/07 Tr. 18:15-19:5 (Parsons) (explaining that XM had to have something that was clearly differentiable from free terrestrial radio in order to get people to pay for the service); Parsons WDT ¶¶ 27-28; Karmazin WDT ¶¶ 41-42 (explaining that, to be successful, Sirius needed to develop compelling, exclusive programming that people were willing to pay for and therefore it began to focus on non-music programming).

290. Despite compelling evidence in the record that the exclusive rights obtained by the SDARS in their non-music programming deals are more valuable and cost a great deal more than non-exclusive rights (all else equal), Dr. Pelcovits' analyses do not adjust or account for any differences in the exclusivity of the rights granted by the various non-music programming agreements, on the one hand, and the non-exclusive sound recording performance license, on the other. In other words, consistent with its theme of capturing value it does not contribute, SoundExchange seeks to be paid for a non-exclusive license on the same basis as licensors are paid for exclusive licenses.

291. SoundExchange defends Dr. Pelcovits' approach by arguing that (i) exclusivity "is thus irrelevant for valuation purposes," because all that matters with programming is subscriber draw (SX PFF ¶ 454) and (ii) the SDARS' music programming is every bit as

"exclusive" as their non-music programming. *Id.* ¶¶ 456, 460; *see generally id.* ¶¶ 454-61; *see also id.* ¶ 177. Both arguments are contrary to the facts and to economic reality.

**(1) The Full Cost and Value of Exclusivity Are Not Reflected in Subscriber-Draw Surveys.**

292. The record demonstrates that subscriber draw directly attributable to the content is not the sole measure of the value of program content to the SDARS. Mr. Karmazin explained that the value of the exclusive non-music deals must be measured by the numerous benefits they confer, many of which are not reflected in the response of subscribers to surveys. These include credibility with OEM partners (in particular those considering whether to renew contracts and whether to install satellite radios in their cars), credibility with Wall Street, and broad publicity and promotional benefits. *See* 8/22/07 Tr. 146:11-158:21 (Karmazin); 6/5/07 Tr. 23:4-24:6 (Parsons) (the value of programming cannot be measured solely by audience).

293. Daryl Martin confirmed that "the benefits [of the exclusive non-music deals] were not only subscriber share capture directly attributable to the brand, they were the indirect benefits. Credibility and financial markets, credibility with the OEMs and the retailers of building a robust value proposition for customers. . . . Of getting consumer acceptance in the marketplace." 8/21/07 Tr. 80:8-16 (Martin); *see also* 8/20/07 Tr. 285:19-286:15 (Martin) ("The OEMs and the retailers have to be convinced that you have a service that is stable, that is secure, that has the wherewithal to compete in the marketplace to justify them putting radios as standard options in cars."); Joachimsthaler WRT ¶¶ 65-74 (testifying that the SDARS' association with strong non-music programming brands have, *inter alia*, "made it more likely that automobile manufacturers will pre-install satellite receivers in their vehicles" and "enhanced the SDARS' financing options").

294. SoundExchange argues that Sirius already had a number of OEM contracts in place months before it announced its deals with the NFL and Howard Stern, SX PFF ¶ 481, but ignores that these contracts did not obligate manufacturers actually to install Sirius radios in their cars. 8/22/07 Tr. 252:20-253:3 (Karmazin); Karmazin WRT ¶¶ 7, 12, 13, 16 (discussing effect of Sirius exclusive non-music deals on its relationships with car makers). By persuading car makers to install radios in their cars, these agreements were a direct cause of additional subscriptions, including subscriptions by consumers who might identify music as their primary reason for subscribing. Therefore, the benefits that these exclusive deals brought to the SDARS by providing credibility with the OEMs were very real and substantial.

295. SoundExchange also relies heavily on Professor Wind's survey (*see* SX PFF Part IV.B) which did not attempt to measure how subscribers became aware of satellite radio and thus cannot measure the value of various types of programming in attracting subscribers. For example, a subscriber who does not care for Howard Stern may first have been made aware of the diversity of Sirius' programming through the enormous publicity that Sirius received as a result of its deal with Howard Stern.

296. Further, Professor Wind's survey made no effort to measure the value of exclusive non-music programming insofar as it induced a particular subscriber to choose one satellite radio service over the other. For example, a subscriber who identified "music" as a primary reason for subscribing and listening to XM may have viewed the musical offerings on both Sirius and XM as equivalent but chose XM because it also offered Oprah Winfrey, who is not available on Sirius. The fact that Oprah Winfrey provided the "tipping point" for this subscriber to choose XM over Sirius means that the Oprah Winfrey channel is entitled to substantial credit for attracting this subscriber.

### (2) The Valuable Exclusive Rights Conveyed by Many of the Non-Music Programming Agreements Is Not Equal to Alleged "Effective" Exclusivity of Certain Kinds of Music Played on the SDARS.

297. SoundExchange also attempts to negate the enormous value paid for, and conferred by, exclusivity by arguing that the nonexclusive sound recording performance statutory license used by the SDARS is "effectively exclusive," providing the SDARS with "an important and valuable type of exclusive content – exclusive vis-à-vis terrestrial radio." *Id.* ¶¶ 456, 460; *see generally id.* ¶¶ 454-61; *see also id.* ¶ 177. It also fails to ascribe any premium value to grants of less than completely exclusive rights as to all media. *See id.* ¶¶ 462-64.

298. SoundExchange's attempt to equate the enormous exclusivity value for which the SDARS bargained and paid in many of their non-music programming agreements with the value of the music played on the SDARS because it allegedly is "exclusive vis-à-vis terrestrial radio" (*Id.* ¶¶ 456, 460) fundamentally misunderstands how exclusive rights are priced in the market. Exclusive rights are valued based on the price that licensees pay, and licensors demand, for the specific exclusive rights bargained for in a license negotiation. As George Benston testified, "exclusivity is valuable," and "the price that's commanded in the marketplace is going to reflect that exclusivity." 8/20/07 Tr. 91:17-22 (Benston). Professor Benston further testified that when comparing nonexclusive content with content that has an element of exclusivity, "you'd better adjust for the difference." *Id.* 92:3-4. Dr. Pelcovits' failure to make any such adjustment invalidates his analyses.

299. A licensee is only willing to pay a significant exclusivity premium to be certain that the licensed content will not be transmitted over certain other media. If, at any time, other media could start transmitting that licensed content, the licensee would not pay more. As Mr. Karmazin described: "[T]he reason that I'm willing to pay money for Howard Stern is

because I have exclusivity. I don't get exclusivity from the music business. . . . [Y]ou can hear music on terrestrial radio, you can hear music in a lot of places. I don't get exclusivity." 8/22/07 Tr. 166:18-167:2 (Karmazin). He further explained:

> I think this is about how much money should we pay for the rights we're getting[.] The rights they're giving us, whether I have de facto exclusivity, [SoundExchange is] not giving us that right, and they're not assuring us that we have that right. . . . They're not giving us exclusivity. And they're not giving us the rights of knowing that we have it alone.

*Id.* 178:17-179:3; *accord id.* 167:9-15; Parsons WDT ¶ 20 (exclusive content "commands a high price"); Logan WDT ¶ 25 (XM "often pays premium" for exclusive programming because it "can distinguish XM from competitors in satellite and internet radio, as well as terrestrial radio"); 6/21/2007 Tr. 248:6-8 (Renshaw) ("[E]xclusivity is a value that people are willing to pay for in the marketplace.").

300. Messrs. Parsons and Karmazin also made clear that music does not convey any such exclusivity. As Mr. Parsons testified:

> [A]ll of our competitors have equal access to the same library of music. Any broadcaster and webcaster can play the same CDs that XM plays. A nonexclusive sound recordings license does not, by itself, differentiate XM from the many competitors that also have that license, or from terrestrial broadcasters that are exempt from that license requirement.

Parsons WDT ¶ 43; *see* Benston WRT at 5 (observing that "the benefit of exclusivity is not present for the sound recording performance right").

301. When pressed to explain why a claimed lack of a "New Wave" music channel in New York City did not amount to functionally the same type of exclusivity for which licensees pay hefty premiums, Mr. Karmazin responded that "there's nothing that stops any radio station in New York City that believed there was a market or business opportunity" in New Wave music from starting such a station. 8/22/07 Tr. 172:14-18 (Karmazin); *id.* at 173:11-18 ("in 30 minutes,

as long as it takes me to take those CDs, you know, that SoundExchange provides the radio station, I can change that format. I can change that format any time I wanted to").

302. Licensors similarly place enormous monetary value on granting exclusive rights to perform certain content because of the opportunity costs in foregone revenue from the ability to license that content to other services. SoundExchange witness Larry Kenswil of Universal Music Group unambiguously volunteered this concession when, asked if he would consider granting exclusive rights to an interactive music service (to which sound recording copyright owners have the ability to grant exclusive rights), responded that there was no price high enough that would justify offering that sort of exclusive. 6/27/06 Tr. 87:16-88:5 (Kenswil).

303. Edgar Bronfman, Jr., Warner Music Group's Chief Executive Officer, likewise acknowledged that "the exclusivity that other content can provide to one satellite operator or the other . . . is different than what [WMG] can provide" and that he therefore "was not suggesting that [WMG] be compensated the same as Major League Baseball or Howard Stern." 6/20/2007 Tr. 114:19-115:3 (Bronfman).

304. Moreover, as discussed in the SDARS' Proposed Conclusions of Law, precedent confirms the fundamental point that exclusive rights are valued based on the price that licensees are willing to pay for them, not on whether consumers – strangers to the license transaction – perceive such exclusivity to exist. *See* SDARS PCL Part V.B.

**(3) Any Perceived Exclusivity of Music that Is Not Played on Terrestrial Radio Is Due to the SDARS' Contribution to the Service, Not to any Exclusive Rights Granted by the Record Labels.**

305. SoundExchange incorrectly seeks to misappropriate to itself the value of any alleged *de facto* exclusivity to consumers of the broad selection of sound recordings played by the SDARS. SoundExchange contends that the extraordinary efforts of the SDARS to offer what

SoundExchange admits is "a breadth and quality of music choice that is not and inherently cannot be provided by traditional radio" (SX PFF ¶ 458 (quoting Blatter WDT ¶ 19) gives rise to *de facto* "exclusivity" of the SDARS' music programming for which SoundExchange claims it is entitled to extract a premium.

306. SoundExchange seeks to reap where it has not sown. Any uniqueness of the SDARS' music offerings is due to the combination of the nationwide delivery platforms they have designed and built and their programming decisions. It has nothing to do with any rights granted by SoundExchange. The fact that the SDARS' business models offer what SoundExchange concedes is a more comprehensive variety of music programming than terrestrial radio does not arise out of exclusivity granted by SoundExchange, and it therefore does not constitute justification for paying a premium to SoundExchange. Rather, it is the SDARS that should be rewarded for making available to the public this variety and depth of music, as discussed in Part V.B of their Proposed Findings and in *supra* Part III.A.

307. Sirius, XM, and, indeed, terrestrial radio all have access to the exact same repertory of sound recordings and to the exact right to perform them. Stated differently, if SoundExchange were to offer XM or Sirius exclusive radio rights to the music its members license, the value of such a license would be many times its present value. *See* 8/22/07 Tr. 145:8-18 (Karmazin) (testifying that exclusivity has "great value" and the amount he would pay for content would vary with the amount of exclusivity obtained).

308. The converse is also true: where, as here, the rights that SoundExchange offers the SDARS are nonexclusive – indeed, they are, by virtue of statutory restrictions, more constraining than those available to terrestrial radio – there is no legitimate basis for SoundExchange to be remunerated as if the rights were instead exclusive. *See id.* Tr. 171:9-13

(Karmazin) ("[I]f we have a channel that . . . plays a certain type of music, there's nothing that precludes any terrestrial radio station or HD radio station from playing the same music.").

**(4) Limited Exclusivity, Including Satellite Radio Exclusivity, Has Substantial Value.**

309. SoundExchange also seeks to negate the exclusivity value in many of the SDARS' non-music programming agreements by claiming that "even the non-music programming that the SDARS claim justifies high prices is not actually exclusive." SX PFF ¶ 462. But SoundExchange's suggestion that only exclusivity, as against all media, has value is incorrect.

310. On one end of the exclusivity spectrum is Sirius' agreement with Howard Stern. Pursuant to the terms of the agreement, Howard Stern is exclusive to Sirius vis-à-vis XM, terrestrial radio, and all other audio services. SX Trial Ex. 27 at SIR00014072. Accordingly, because Howard Stern "cannot do anything else in the audio entertainment" arena because "his services are exclusive to Sirius," the amount of money that Mr. Stern sought, and Sirius paid, for this contract was substantial, totaling hundreds of millions of dollars. 8/22/07 Tr. 144:8-10 (Karmazin).

311. XM's agreement with HARPO Radio, Inc. to transmit Oprah Winfrey programming is another example. That agreement grants programming and marketing exclusivity as against "[[ ]]." SX Ex. 132 DR at XMCRB 00034935, XMCRB 00034930. XM paid a substantial amount for such exclusivity. Ms. Winfrey's television show and magazine contain content different from the original content she developed for XM.

312. Contrary to SoundExchange's suggestion (*see* SX PFF ¶¶ 463-64) even non-music programming agreements granting Sirius or XM exclusive rights vis-à-vis each other but

not vis-à-vis terrestrial radio or other media command significant premiums. As Daryl Martin demonstrated, exclusivity within the satellite radio industry (*e.g.*, the fact that Sirius has Howard Stern and NFL and XM does not, and *vice versa* with respect to Oprah and MLB) is extremely valuable. *See, e.g.*, Martin and Parr WRT at 13-15. And as Mr. Karmazin testified: "[E]ven if we have exclusivity only to XM or only to terrestrial radio . . . [it] will have great value." 8/22/07 Tr. 145: 8-12 (Karmazin).

313. This value is reflected in two major sports agreements – Sirius' agreement with the NFL and XM's agreement with MLB, which include provisions that [[

]].

SDARS PFF ¶ 1044. Notably, these agreements convey exclusivity only as against other satellite radio services. Other agreements granting exclusivity vis-à-vis the other satellite radio service but not vis-à-vis terrestrial radio – such as Sirius' agreements with Martha Stewart and NASCAR – likewise convey significant value by that limited exclusivity grant. *See* SX Trial Ex. 32 at SIR00027593; SX Trial Ex. 23 at SIR00041611. By contrast, XM has exactly the same sound recording performance rights as Sirius, and neither obtains any other rights from SoundExchange. *See* 8/22/07 Tr. 178:19-179:3 (Karmazin).

314. SoundExchange's attempt to equate the exclusivity expressly granted by the NFL agreement with alleged *de facto* exclusivity of certain types of music thus is misguided. *See* SX PFF ¶ 461. As discussed above, Sirius' NFL contract specifically grants Sirius exclusive satellite radio broadcast rights. SX Trial Ex. 36 at SIR00040090. Moreover, as Mr. Karmazin testified, Sirius obtained effective assurance that the NFL would not grant to terrestrial radio the same rights as Sirius obtained, due to the structure of the league and the relationships among team owners. 8/22/07 Tr. 195:16-196:13 (Karmazin) (cross market terrestrial rights would

"totally undermine" the current league practice and "it has not happened[,] for the most part, in the history of the NFL."). By contrast, terrestrial radio stations do not need consent from anyone analogous to NFL owners to broadcast any sound recordings they want.

* * *

315. In sum, the significant premiums paid by the SDARS for varying degrees of programming exclusivity must be quantified and deducted from the cost of non-music programming agreements (along with other deductions discussed below) before those agreements can provide a valid benchmark for valuing the nonexclusive sound recording performance right at issue here. *See* 8/20/07 Tr. 91:17-92:4 (Benston) (testifying that use of the cost of any non-music content deal entered by the SDARS as a benchmark for the sound recording right must first include deductions for the value of exclusivity).

**b. SoundExchange Does Not Even Attempt To Dispute That the SDARS' Non-Music Content Agreements Convey Valuable Trademark and Brand Exploitation Rights as well as Promotion and Endorsement Benefits.**

316. SoundExchange does not seriously dispute the fundamental point testified to by the SDARS' senior executives and multiple experts: that the non-music programming agreements forming the basis of Dr. Pelcovits' models grant rights, and include large payments for rights, that are not provided by the statutory sound recording license. Although SoundExchange takes shots at the SDARS' experts' analyses valuing those rights, the existence of these non-content dimensions of value is indisputable. Dr. Pelcovits' failure to acknowledge them, let alone account for their value, is another reason his non-music programming models are invalid.

**(1) Unlike the SDARS' Major Non-Music Programming Agreements, the Sound Recording Performance Right Being Valued in this Proceeding Conveys No Trademark or Brand Exploitation Rights and Imposes No Promotional or Endorsement Obligations on Record Companies or Artists.**

317. SoundExchange does not argue that the sound recording performance license grants the SDARS the right to exploit the trademarks, logos, or images (in short, the "brand") of any record company or performing artist in their advertising, promotional materials, or marketing. Nor does SoundExchange argue that the sound recording license obligates any record company or artist to endorse the SDARS or to actively promote the SDARS or any SDARS programming. But these rights and benefits are conveyed to the SDARS in exchange for significant consideration in the non-music programming agreements Dr. Pelcovits uses as benchmarks. Using a non-music programming benchmark model without adjusting for the value of these benefits effectively credits SoundExchange with the value of rights it is not granting and obligations it is not undertaking.

318. Rather than make appropriate adjustments to account for these differences, SoundExchange argues that "music" also has brand value (SX PFF ¶ 465) citing the testimony of Dr. Joachimsthaler that rock bands can have brand equity. *Id.* ¶ 474.[28] But that is utterly irrelevant to pricing the sound recording performance license. Whatever brand value music or sound recordings may have, the right to exploit that value through the use of trademarks, logos, and images in advertising and promotional material is not conveyed to the SDARS by the sound recording performance right at issue here. Nor is that value conveyed by the right to make

[28] Dr. Joachimsthaler did not testify to the very different proposition that sound recordings, by themselves, carry brand value that accrues to a radio service that plays them, as SoundExchange implies. *See* SX PFF ¶ 474. To the contrary, his testimony makes clear that because sound recordings "are ubiquitous – freely and widely available on a myriad of terrestrial radio stations and from numerous other sources," they do not confer brand value to services that merely perform those recordings. Joachimsthaler WRT ¶ 24.

performances, which is non-exclusive and merely conveys the ability to play the same sound recordings that terrestrial radio and other services also have the right to play. *See* Joachimsthaler WRT ¶ 75 ("[T]he deals entered into by the SDARS with the Non-Music Content Providers bring tremendous brand value to the SDARS beyond that of the content that sound recordings alone simply cannot."); *see also id.* ¶ 22.

319. Mr. Karmazin confirmed that the performance right Sirius receives from SoundExchange – the right to play the recordings – does not include the right to exploit the recording artists as "brands":

> Sirius' right to play recordings by Waylon Jennings, Rihanna, Led Zeppelin, Linkin Park, Tony Bennett, Jay-Z or Madonna does not confer any ability for Sirius to use those artists['] names or likenesses to promote its music channels or service. Instead, Sirius must contract separately for such branding and promotion rights, and has done so both in offering specialty channels (such as Elvis Radio, Siriusly Sinatra, The Rolling Stones Channel, The Who Channel, Jimmy Buffet's Margaritaville Channel, Eminem's Shade 45, and, soon, the Grateful Dead Channel) and special programs (such as 50 Cent's program on Shade 45, Little Steven Van Zandt's Underground Garage, and Tony Hawk's and Lance Armstrong's programs on Faction).

Karmazin WRT ¶ 21. To promote the artists or to use their trademark, Sirius has to pay extra. *See* 8/22/07 Tr. 159:17-160:21 (Karmazin) ("[W]e're not receiving any of the promotional value or associations with those artists. We do get to play them and I'm not underestimating that. . . . But we don't get the same kinds of things we get from our non-music branded content."); *id.* at 155:18-157:2 (Karmazin) (describing payment to Jimmy Buffet in connection with rebranding Vacation channel as Margaritaville); *see also* Joachimsthaler WRT ¶ 24 (stating that SDARS pay a premium to operate exclusive branded channels and exclusive shows hosted by artists); Benston WRT at 9 (observing that, as compared to non-music programming deals, "[t]he sound recording performance right does not provide similar brand value, as it grants no right to the SDARS to use famous consumer brands").

320. Moreover, SoundExchange does not contend that either the record companies or any performing artists are obliged by the sound recording performance right to endorse Sirius' and XM's services (and they are not).

321. In sum, whatever brand equity musical groups may carry, no such equity is conveyed to the SDARS by the limited performance right at issue in this proceeding.

**(2) Dr. Joachimsthaler's Analysis Confirms the Value of the Powerful Trademark and Brand Exploitation Benefits Provided by the Non-Music Content Agreements.**

322. Nothing in SoundExchange's submission even attempts to discredit Dr. Joachimsthaler's demonstration that each of the non-music deals he analyzed involved strong brands that the SDARS acquired the right to exploit by advertising and promoting the content partners' logos, trademarks, and images. *See* SDARS PFF ¶¶ 1171-79.

323. SoundExchange also misses the point of Dr. Joachimsthaler's bank hypothetical, which bolstered his conclusion that the brand value of the non-music deals justified the premium prices the SDARS paid for them. *See* SX PFF ¶¶ 466-84. As Dr. Joachimsthaler explained, the right to play sound recordings – the minimum requirement for a radio service that chooses to compete as a music service – is a "point of parity" for which one does not pay a premium because it is not, by itself, "a source of competitive advantage." Joachimsthaler WRT ¶¶ 24-26. If "need" were the primary driver of price, then the price of water would be exorbitant, whereas diamonds would be more moderately priced, as SDARS expert Professor George Benston explained. *See* Benston WRT at 6-7.

324. SoundExchange recognizes this point when it suits its purpose, acknowledging that "[n]umerous products and services require multiple inputs, but that fact alone does not lead to price parity across those inputs to the buyer." SX PFF ¶ 1381. It notes, for example, that "the

SDARS require both satellites for transmission and recorded music for content" and then admits that "nobody is suggesting that . . . they should be priced the same to the satellite radio company," *id.*, thus conceding the invalidity of its attempt to justify a premium for an input that is necessary but widely available.

325. By contrast, the non-music deals Dr. Joachimsthaler analyzed "provide the compelling and exclusive content that serves as clear category points of difference for Sirius and XM," Joachimsthaler WRT ¶ 26, by providing content that cannot be heard on either the other satellite radio service or on terrestrial radio. *Id.; see also* 8/22/07 Tr. 40:17-41:3 (Silverman) ("[I]t's very, very important to find ways to differentiate a product, a service, from each other. Consumers need to find something to latch onto so that they can say this product or service is different than that product or service. And the talk deals, the nonmusic deals really helped achieve that"). Because sound recordings do not provide these benefits, they properly do not command a premium.

**(3) SoundExchange Does Not Question the Fundamental Fact that the Rights Mr. Martin Valued Have Significant Value.**

326. SoundExchange does nothing to undercut the bedrock principle established by Mr. Martin's testimony and analysis: Trademark and brand exploitation rights, endorsement and promotional obligations, and exclusivity are highly valuable rights for which the SDARS paid a significant portion of the contract cost in the six non-music agreements he analyzed. *See* Martin and Parr WRT at 38. The questions SoundExchange raises as to the reliability of the licensing information Mr. Martin used for benchmarking purposes (SX PFF ¶ 489) besides being factually unfounded, do not rebut this fundamental point.[29]

[29] Indeed, as the SDARS showed in their Proposed Findings of Fact, those non-content benefits are not mere theoretical constructs: they were specifically contemplated in the

327. Nor has SoundExchange provided any alternative analysis of the value of these contract rights and obligations. As the party proffering these non-music agreements as benchmarks, it is incumbent on SoundExchange either to (a) establish that these rights have zero value or (b) offer an alternative valuation of these rights and adjust its benchmarks accordingly. SoundExchange does neither.

328. It is not necessary to rebut every one of SoundExchange's attacks on Mr. Martin's calculations, none of which have merit and none of which, in any case, affect the thrust of his testimony. It is worth noting, however, that in estimating the brand and endorsement elements of the non-music agreements, Mr. Martin drew upon industry-accepted data sources and methodologies relied upon by other experts in the field. *See* 8/20/07 Tr. 273:6-11 (Martin); *id.* at 243:10-18. He also drew upon the collective experience of a team knowledgeable in valuing intangible assets, which allowed him to make reasonable judgments as to appropriate value ranges for the respective transactions. *See id.* 293:19-294:7 (Martin) ("[Y]ou utilize or reply upon your industry experience and specific client experience and your understanding of royalty rates that are evident in actual deals to corroborate your position and give you a high level of confidence that your analysis is representative of the real world."); *id.* at 253:4-8.

329. SoundExchange criticizes Mr. Martin's use of license agreement summaries as opposed to the actual license agreements in his analysis (*see* SX PFF ¶¶ 486-89), but, as

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contracts. *See* SDARS PFF ¶¶ 1160-1215; *see also, e.g.*, 6/5/07 Tr. 22:22-23:3 (Parsons) (stating with respect to XM's Oprah Winfrey deal that "a majority of the cost of that service is . . . the marketing deal" and that the programming content is a "minor portion" of it); Vendetti WRT ¶ 17; SX Ex. 20 at XMCRB 00034933; 6/6/07 Tr. 174:18-176:18 (Cook) (discussing promotional requirements of XM contract with Harpo Productions); 8/22/07 Tr. 152:6-17 (Karmazin) (Sirius also is able to place the NFL on some of its radios "so that when a consumer is going into Best Buy or Circuit City to buy a radio, they will see the NFL brand attached to our product."); SX Ex. 36 at SIR00040091 (specifying [[ ]] reduction in compensation should the NFL enter into a similar agreement with XM); Karmazin WRT ¶ 9 (Stern agreement grants Sirius the right to use Mr. Stern's name, likeness and brand in its point-of-sale materials at retail outlets and in car dealerships, as well as in print advertising and television commercials).

Mr. Martin testified, these reports were obtained from a database that is highly reliable and is frequently utilized by licensing experts in the field for this purpose. *See* 8/20/07 Tr. 242:12-243:14 (Martin).

330. SoundExchange also objects to Mr. Martin's application of an industry standard 25% upward adjustment for exclusivity of the brand exploitation and endorsement elements of the contracts at issue. SX PFF ¶ 503. But, as Mr. Martin testified, "[i]t is well documented that licensors will pay a premium to control the exclusive rights to a property." Martin and Parr WRT at 11 n.4. Mr. Martin testified that, based on industry literature and extensive experience, "the exclusivity premium was determined to be 25 to 50 percent" but, to be conservative, he "added a 25 percent premium to each of the concluded royalty rate ranges." 8/20/07 Tr. 245:11-246:7 (Martin). SoundExchange has not adduced any evidence that contradicts the applicability of this premium.

331. SoundExchange's attacks against the comparability of the license agreements used by Mr. Martin to determine the endorsement and brand value of the SDARS' non-music programming agreements are meritless. SX PFF ¶¶ 504-06. All of the benchmark agreements were selected after careful analysis and the experience of Mr. Martin and his team members, and in many cases undervalued the rights of super-premium properties such as Howard Stern. 8/20/07 Tr. 248:5-19, 312:11-15. (Martin). Nor is the age of some of the comparable license agreements Mr. Martin used of any concern (*see* SX PFF ¶ 499) because an "as of" analysis must be based on data available to the buyers and sellers on the date when each the specific content agreement was executed. 8/20/07 Tr. 255:16-21 (Martin). SoundExchange erroneously concludes without support that the omission of lower priced deals that SoundExchange counsel located would have "substantially lowered" the endorsement carve-out. *Id.* ¶ 505. No such

effect would have occurred because in a quartile analysis such as used here, the addition of the few lower priced agreements to the bottom quartile would have had limited, if any, effect on the upper quartiles; these merely would stretch slightly wider between the maximum and the median. *See* Martin and Parr WRT, Consor-Ex. 6.

332. SoundExchange's criticism of the 26.61% operating margin as not based on the SDARS' retail revenues, SX PFF ¶ 507, again shows only that it did not understand the analysis. Mr. Martin testified that the relevant number for his analysis is wholesale revenue that approximated the cost of goods sold by the manufacturer to the retailer, grossed up by a profit margin to the manufacturer – not sales by the retailer to the consumer. 8/20/07 Tr. 246:11-247:3 (Martin); *id.* at 291:1-5.

333. In sum, SoundExchange's attacks on the mechanics of Mr. Martin's computations of the value of brand and trademark exploitation rights, endorsement and promotional obligations, and exclusivity for the evaluated non-music properties do not even take issue with the larger point his testimony establishes: the amounts paid by the SDARS for non-music programming included the acquisition of substantial non-content assets, which Dr. Pelcovits ignored in his use of the non-music deals.

### c. SoundExchange Does Not Dispute that the SDARS' Non-Music Content Agreements Generated an Enormous Amount of Valuable Publicity.

334. Likewise, SoundExchange's attacks on aspects of Bruce Silverman's analysis of the valuable publicity generated by the SDARS' deals with Howard Stern, Oprah Winfrey, NFL, MLB, Martha Stewart, and Opie & Anthony do not alter the inarguable fact that these non-music deals generated enormous media coverage for the SDARS that would have cost the SDARS millions of dollars had they purchased equivalent print and television advertising. *See* 8/22/07 Tr. 106:1-13 (Silverman) (Stern); *id.* at 115:16-116:12 (NFL); *id.* at 116:21-117:8 (Martha

Stewart); *id.* at 117:9-21 (NASCAR); *id.* at 117:22-118:11 (MLB); *id.* at 118:12-119:1 (Oprah Winfrey); *id.* at 119:2-13 (Opie & Anthony). *See also, e.g.*, SDARS PFF ¶¶ 89, 90; 6/12/07 Tr. 17:4-19 (Frear) (describing "staggering" impact of Stern deal); 8/22/07 Tr. 92:19-94:6 (Silverman) (describing enormous publicity generated by Stern deal and stating that it "was treated as a major news item and got huge coverage across the country"). Dr. Pelcovits' failure to take into account any of this publicity value in his non-music programming analysis is yet another reason that analysis is invalid.

335. SoundExchange cannot dispute that, as Mr. Silverman testified, the desire to generate media "buzz" for the SDARS was one of the reasons that the non-music agreements were executed, and the "advertising value" estimates Mr. Silverman arrived at illustrate that the publicity generated by these deals had significant value to the SDARS. *See id.* 106:1-13, 116:3-119:13 (Silverman); SDARS PFF ¶ 1219. As Mr. Silverman testified: "[T]hese particular deals were clearly intended to try to elicit lots of publicity and publicity has huge value in . . . marketing communications because it's basically advertising you don't have to pay for." 8/22/07 Tr. 43:5-10 (Silverman); *see generally* Coleman WDT at 9 (observing that when he and his colleagues consider whether to create a new non-music channel, they assess whether they can "create a 'buzz' around the channel").

336. Moreover, the "advertising value" estimates Mr. Silverman arrived at illustrate that the publicity generated by these deals had significant value to the SDARS. *See* 8/22/07 Tr. 106:1-13, 116:3-119:13 (Silverman); SDARS PFF ¶ 1219. Under no circumstances could sound recordings alone generate this type of publicity and advertising value for Sirius. *See* 8/22/07 Tr. 261:6-15 (Silverman). Notably, SoundExchange itself has pointed to no evidence that the fact that the SDARS play commercial-free music generated anything close to the amount of publicity

as did the non-music deals Mr. Silverman analyzed. *See* Benston WRT at 5 (the amounts paid by the SDARS for these non-music programming deals reflect valuable promotional benefits to the SDARS that are not obtained from the sound recording performance right). Dr. Pelcovits' failure to account for even a portion of these benefits in his use of non-music programming agreements as benchmarks invalidates his benchmark model.

337. SoundExchange points to an alleged "random sampling" of a few of the more than 4,000 articles to challenge his testimony. SX PFF ¶¶ 514-16. In fact, out of more than 4,000 articles qualified by Mr. Silverman, SoundExchange presented a mere six hand-selected articles in challenging Mr. Silverman's analysis. But even among that cherry-picked handful of articles, Mr. Silverman demonstrated that there were good reasons for including them. *E.g.*, 8/22/07 Tr. 298:11-22, 299:15-19 (Silverman) (pointing out that challenged article included a photograph of Mr. Stern along with the caption "for good or bad Howard Stern raised the public profile of satellite radio when he joined Sirius this year").

338. SoundExchange claims that Mr. Silverman's equivalent advertising cost analysis is "meaningless" because it does not measure "value" to the SDARS of such coverage, citing Mr. Silverman's statement that, in theory, it would "be cheaper to get a series of op-eds planted in newspapers as opposed to actually running an ad in those same newspapers. SX PFF ¶¶ 510-11. As a practical matter, however, "[y]ou can't buy publicity," and, in Mr. Silverman's experience, "there really are serious barriers in between the editorial departments and the advertising departments with most media" 8/22/07 Tr. 56:20, 58:1-4, 58:10-13 (Silverman). Mr. Silverman made clear that the way that publicity firms would go about measuring the value of such publicity is by calculating the equivalent advertising cost of purchasing that publicity, which is precisely what Mr. Silverman did. *Id.* 63:6-13; *id.* at 60:15-19.

339. SoundExchange's effort to demonstrate that Mr. Silverman inflated the number of "hits" credited to the non-music deals overlooks the many, far more significant, ways in which Mr. Silverman intentionally undercounted the actual publicity generated by the non-music agreements he analyzed. Specifically: (i) Mr. Silverman did not examine all of the television stations in the country, but only those in the top 20 markets (*id.* 50:8-18); (ii) his print media search encompassed only newspapers in major metropolitan areas and a very small universe of magazines (*id.* at 81:16-83:7); (iii) his analysis did not quantify the value of photographs included within print media (*id.* at 83:8-84:5); (iv) except for Howard Stern's show on terrestrial radio, Mr. Silverman did not analyze any value generated by radio (*id.* at 80:4-81:1); and (v) Mr. Silverman did not measure any publicity the SDARS received on the Internet (*id.* at 81:2-7).[30]

340. In sum, for all of SoundExchange's attacks on Mr. Silverman's analysis, none of those attacks undermine Mr. Silverman's essential point that the SDARS' non-music programming agreements generated huge, valuable publicity of a magnitude that merely playing music cannot do. Indeed, his analysis significantly understates the value of that publicity. Dr. Pelcovits' failure to take into account even some of this publicity in his non-music programming model invalidates that model as a benchmark in this case.

### 3. SoundExchange's Analyses Rely on the Deeply Flawed Wind Study, Which Greatly Over-Values Music Programming.

341. The Stern and non-music programming analyses both rely on the Wind study, specifically the 56% result generated by the so-called "willingness-to-pay" question, for the

[30] After the SDARS filed their Proposed Findings of Fact, they noticed one paragraph relating to this undercounting discussion that included a few inadvertent citations to Mr. Silverman's Written Rebuttal Testimony. SDARS PFF ¶ 1220. The text above makes the same substantive points concerning the ways in which Mr. Silverman understated the equivalent advertising cost of the publicity the SDARS received as a result of their various non-music programming agreements but only cites to Mr. Silverman's oral testimony of record.

alleged value of music programming. *See* SX PFF ¶ 561 (reliance on the Wind study's "willingness-to-pay" question in the Stern analysis); *id.* ¶¶ 573, 579, 588 (reliance on the Wind study in the non-music programming analysis).

342. The SDARS' Proposed Findings of Fact identified numerous reasons why the Wind study grossly overstates the value of music programming. *See* SDARS PFF Part VII.A.2 (identifying flaws, including, among others, reliance on all-or-nothing cartel value sought in "willingness-to-pay" question ¶¶ 934-937, the "tires-on-the-car" flaw ¶ 928, the "voice of counsel" flaw ¶¶ 931-933, and the leading nature of the "willingness-to-pay" question ¶¶ 931-933); *see supra* Part IV.A.

#### 4. SoundExchange's Analyses Misappropriate Credit for the Value of Music Programming Not Contributed by Copyrighted Sound Recordings.

343. In both the Stern and general non-music programming cost analyses, SoundExchange further seeks to inflate its fee entitlement by misappropriating credit for the value that the SDARS, music publishers, live performances, and non-copyrighted sound recordings contribute to music programming. This value is not contributed by the recording industry and therefore should not figure in the price of the sound recording performance license.

344. This analytical flaw stems from Dr. Pelcovits' treatment of the SDARS' non-royalty costs of music programming and the musical works royalty. In both analyses, after determining a putative "value" of the music programming (which includes value contributed by the SDARS, music publishers, live performances, and pre-72 sound recordings as well as the sound recording rights represented by SoundExchange), Dr. Pelcovits simply subtracts the costs incurred by the SDARS for these other programming elements, including the musical works royalty, and allocates all remaining value to the sound recordings share. *See* SX PFF ¶¶ 562 (discussing the Stern analysis); *id.* ¶ 577 (discussing non-music programming analysis).

345. As a consequence, to the extent the SDARS' expenditures for musical works and their own programming costs contributed more value than they cost, SoundExchange seeks to appropriate that value for sound recording rights. The normal expectation, of course, is that the buyer obtains surplus from its expenditures; otherwise, it would not make the expenditure.

346. The record is clear that the SDARS' contributions to music programming (and the contributions of pre-'72 sound recordings) have substantial value beyond the costs incurred. *See* SDARS PFF ¶¶ 920-22; *supra* Part IV.B. (discussing Professor Hauser's Internet survey, showing that the value of non-SoundExchange programming contributions exceed the value of SoundExchange's post-'71 sound recordings by more than 2-1).

347. Dr. Pelcovits, for example, subtracted costs representing just [[ ]] of revenue to account for all of these other contributions of the SDARS to their music programming. He allocated [[ ]] of revenue (more than 12 times as much) to the sound recording performance right. Pelcovits AWDT at 3-4, 10-11. SoundExchange's recalculation of the Pelcovits analysis, SX PFF ¶¶ 558, would have the SDARS pay sound recording copyright owners more than 6 times as much as the SDARS pay for their other contributions to music programming.[31] This ratio is far greater than the value that Professor Hauser's study showed copyrighted sound recordings contribute, even under the most conservative reading of Professor Hauser's results.

### B. Dr. Pelcovits' Non-Music Programming Model, If Anything, Supports the Fees Proposed by the SDARS.

348. SoundExchange's discussion of its Non-Music Programming Benchmark exemplifies the result-oriented numbers games upon which its entire case relies.

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[31] This ratio is calculated by adding the "music programming expense" and "music programming equity expense" in SoundExchange Figure 27 to "music programming and content costs" in Figure 28 and dividing the result into the "adjusted benchmark net non-music programming expense" lines on both tables. Musical works royalties, which are contributions by neither the SDARS nor the record companies, were excluded from the computation.

SoundExchange does not even attempt to explain Dr. Pelcovits' use of 2006 for his analysis – a year not even within the relevant license term. Nor does SoundExchange even attempt to reconcile Dr. Pelcovits' advocacy of the use of 2012 for his Shapley/Surplus model with his use of 2006 in the non-music programming model. Dr. Pelcovits' inconsistent selection of years can be explained only by his desire to have his models converge on SoundExchange's desired outcome.

349. Further, SoundExchange implicitly concedes that Dr. Pelcovits erred when he included $82.9 million of Stern costs in his 2006 analysis. Although it never acknowledges it, SoundExchange in its Proposed Findings describes Dr. Pelcovits' analysis as he conceded on cross-examination he intended to do it. However, rather than accept the consequences of that error – a fee below the point of "convergence" SoundExchange advocates – SoundExchange changes Dr. Pelcovits' model in its Proposed Findings and attempts to include all of the Stern costs in order to return to its alleged point of benchmark convergence . As discussed below, 2006 was not an appropriate year to analyze, SoundExchange was right to exclude the Stern costs, and, in any event, SoundExchange errs in its attribution of Stern costs.

350. SoundExchange also asserts that Professor Benston made "three critical errors" in his correction of two of Dr. Pelcovits' key errors. SX PFF ¶ 580. Specifically, SoundExchange argues that: (i) despite the fact that Dr. Pelcovits excluded the Stern costs from his 2006 analysis, it was error for Professor Benston to do so for his 2007-2012 analysis; (ii) Professor Benston erred in his treatment of advertising revenues as an offset to non-music content costs; and (iii) Professor Benston erroneously omitted the early years of the non-music content deals. Each of SoundExchange's critiques of Professor Benston is wrong.

### 1. Dr. Pelcovits' and Professor Benston's Decisions To Exclude Howard Stern Programming Costs Were Correct.

351. Dr. Pelcovits' non-music programming analysis makes its first appearance in the case in his amended written direct testimony. Pelcovits AWDT at 8-11. That testimony was filed after Dr. Pelcovits learned from Sirius' written direct testimony, and from discovery, that Sirius entered into the Howard Stern agreement under extraordinary circumstances, when the future of the company was at risk, and that the Stern agreement provided enormous benefits to Sirius beyond the attraction of subscribers who would identify themselves as subscribing because of Stern. Karmazin WRT ¶¶ 8-15, 20, 22, 25, 26, 28; Frear WDT ¶ 21. Thus, when Dr. Pelcovits performed the non-music programming analysis and excluded Stern, he was aware that the SDARS viewed the Stern agreement as an invalid benchmark and an outlier.

352. Dr. Pelcovits states that his reason for excluding the Stern costs from his non-music programming analysis was because Stern "received substantial compensation in 2006 that is part of multi-year deal." Pelcovits AWDT at 10. But that explanation makes no sense. Most, if not all of the non-music programming deals are "multi-year deals." There was, of course, extraordinary equity income to Mr. Stern in 2006 for achieving certain milestones by the end of that year, but Dr. Pelcovits could have excluded that extraordinary 2006 compensation from the analysis and simply included Mr. Stern's recurring annual compensation. He chose not to.

353. More likely, Dr. Pelcovits was concerned that that the unique characteristics of the Stern deal would vitiate the validity of two of his analyses rather than just his Stern analysis. Or, he may have been concerned that including Stern costs would have required him to argue that the SDARS fee should be based on a year – 2006 – in which Sirius would, by his analysis,

be treated as having to pay more than 100% of its revenue on programming, leaving no revenue for any other use.[32]

354. In fact, as Mr. Frear testified, whatever his reason, Dr. Pelcovits was correct to exclude the Stern deal, which was "one of a kind and was made at a critical time in the company's development." Frear WRT ¶ 20. Professor Benston also recognized "the unique characteristics and circumstances of the Stern agreement" in electing to replicate Dr. Pelcovits' decision to exclude the costs of the Stern agreement from the analysis.

355. Once it was demonstrated on cross-examination that Dr. Pelcovits erroneously included almost $83 million in Stern payments in his intended non-Stern, non-music programming analysis, the result of his analysis dropped to about 13.3% of revenue, 7/9/07 Tr. 275:22-279:13 (Pelcovits); SX PFF ¶ 577, still based on the wrong year, and still without providing any credit for the benefits that the SDARS pay for in their non-music programming deals that are not provided by the statutory sound recording performance license being priced here. SoundExchange implicitly acknowledges that error. Its Proposed Findings of Fact never actually says so; rather SoundExchange simply adopts the results Dr. Pelcovits conceded on cross examination he would have gotten had he subtracted the $82.9 million payment to Stern that he neglected to subtract. 7/9/07 Tr. 278:1-279:13 (Pelcovits) (conceding the result would be 13.3% of revenue, not 18.6; *see* SX PFF ¶ 577.

356. Characteristic of SoundExchange's approach to numbers games, it now, for the first time, rejects the corrected result of Dr. Pelcovits' analysis as understated – because it does

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[32] Specifically, under Dr. Pelcovits' calculation on page 10 of his AWDT, including the Stern non-equity costs would have left Sirius paying non-music programming costs of [[ ]] of its revenue (consisting of the [[ ]] identified by Dr. Pelcovits, plus the Stern annual costs he deducted of [[ ]] million). By Dr. Pelcovits' theory that music programming should cost as much as non-music programming, the analysis would have assumed Sirius programming costs equal to [[ ]] of revenue. [make footnotes same font size as text]

not include Stern! SX PFF ¶ 578. SoundExchange then retools its analysis back into its desired range of convergence, arguing that the Judges should include [[ ]] in allegedly allocable Stern costs.[33] This would result in a theoretical sound recording royalty of 22% of revenue, a number even higher than the result of Dr. Pelcovits' original analysis! *Id.*[34]

357. As the SDARS demonstrate in Part V.C., below, even if Stern is included, when properly analyzed, using the correct years and considering the incremental cost of non-music programming net of other benefits to the SDARS, the result is within the range of rates identified as reasonable by the SDARS.[35]

**2. Professor Benston Treats Advertising Revenues Correctly.**

358. The proper treatment of advertising revenue from the SDARS' non-music programming deals can be illustrated by the following hypothetical: an agreement for non-music content requires a payment by Sirius to the content provider of $10 million dollars, but Sirius is able to sell $4 million in advertising revenues on the programming that it would not have earned absent the agreement. If Sirius decides not to enter the agreement, it has $10 million still in its pocket, no extra subscribers and no incremental advertising revenues. If Sirius does enter the agreement, it no longer has the $10 million, but it has $4 million (from the advertising revenues)

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[33] Moreover, SoundExchange's valuation of the Stern deal is substantially inflated, as it includes not only advertising revenue share, but stock grants fully earned in 2006 and valued at the time of grant, after a substantial increase in Sirius' stock over the anticipated value at the time of the agreement.

[34] SoundExchange does not point out in its Proposed Findings that by making that allocation to Sirius' non-music programming costs, it increases its benchmark for Sirius to [[ ]] (consisting of Dr. Pelcovits' [[ ]] minus the Stern equity of $82.9, plus the newly allocated [[ ]]. This amounts to fully [[ ]] of Sirius' 2006 revenue. *See* SX PFF ¶ 578.

[35] Moreover, SoundExchange's valuation of the Stern deal is substantially inflated, as it includes not only advertising revenue share, but stock grants fully earned in 2006 and valued at the time of grant, after a substantial increase in Sirius' stock over the anticipated value at the time of the agreement.

in its pocket, plus the extra subscribers. In other words, the net cost to Sirius of obtaining the additional subscribers is $6 million, and Dr. Pelcovits' economic theory requires consideration of the cost to the producer.

359. Considering offsetting advertising revenues is particularly important in order to make an apples-to-apples comparison of costs, given that SoundExchange seeks to compare the costs of obtaining subscribers from non-music programming (with advertising) to the costs of obtaining subscribers from commercial-free music programming, which does not generate advertising revenue. *See* SDARS PFF Part V.D.1.c and V.D.2.b.

360. Moreover, the record is clear and undisputed that, in addition to economic logic, this is precisely how the SDARS viewed their non-music content agreements. *See* SDARS PFF ¶¶ 1216-1220.

361. Professor Benston correctly recognized what Dr. Pelcovits did not: advertising revenue obtained from non-music programming is a benefit from the SDARS' non-music programming that is not obtained from music programming. To the extent the SDARS receive benefits that offset the cost of the non-music programming agreements, those benefits must be deducted before determining the incremental net cost to the SDARS of attracting subscribers with non-music programming.

362. SoundExchange criticizes Professor Benston for allegedly "double count[ing] advertising revenue received from non-music content channels by both counting that revenue as part of the SDARS' total revenues but also deducting a portion of that same advertising revenue from non-music content costs." SX PFF ¶¶ 580, 584. SoundExchange then presents an example that it claims proves that Professor Benston's approach yields "absurd results." *Id.* ¶ 585. But Professor Benston was correct; SoundExchange's example turns its own theory on its head.

363. Professor Benston's deduction of advertising revenues from the SDARS' costs of non-music programming (what SoundExchange calls the "numerator" of its percentage-of-revenue benchmark) and his inclusion of advertising revenues in the SDARS' total revenues (the "denominator" of SoundExchange's percentage-of-revenue benchmark) result from the fact that the two numbers serve wholly different purposes in SoundExchange's analysis.

364. The numerator in SoundExchange's model represents the net cost to the SDARS of non-music content. It is this number, under the theory relied upon by Dr. Pelcovits and SoundExchange, that is supposed to represent the amount the SDARS should be willing to pay for music content. As discussed above, it is essential to consider the non-music content costs net of offsetting benefits. For example, in the hypothetical discussed above, the net cost to Sirius of obtaining the additional subscribers is not $10 million, it is $6 million.

365. The denominator serves a different purpose. It is used to develop a percentage-of-revenue rate represented by the applicable net non-music programming costs. Under SoundExchange's theory, the resulting percentage rate is to be applied against the SDARS' revenue to determine the fee. By its own logic, the revenue used in the denominator to determine the percentage rate must be defined in the same way as the revenue against which SoundExchange seeks to apply its percentage rate. Because SoundExchange seeks to apply the percentage against the SDARS' total revenues,[36] the denominator must be total revenues. If advertising revenue is excluded from the denominator, the resulting rate will not generate the

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[36] The SDARS do not believe that a revenue-based fee is appropriate. Woodbury WRT at 97, 27, 48-51, 119; Noll WRT at 12, 73-74, 76-78. Moreover, as discussed below, if a revenue-based fee is adopted, the relevant revenues should be subscription revenues from the audio service, not total revenues, which will include which will include revenues from advertising on non-music channels, subsidized equipment and other unrelated elements. However, this discussion focuses on the analysis as conducted by Dr. Pelcovits and implemented by SoundExchange, which proposes a fee based on percentage of total revenue.

same cost for music programming as the cost of non-music programming that was used to develop the rate in the analysis.

366. The following example demonstrates the need to use, in the denominator, to generate the rate, the same definition of revenue as the revenue against which the resulting rate is to be applied. Assume a service has $20 in revenue, consisting of $19 in subscription revenue and $1 in advertising revenue. Assume further that the non-music programming contract fee is $2 and that programming generates offsetting ad sales of $1, which provide the $1 in ad revenues. The net non-music programming cost to the service would be $1. If that $1 is used in the numerator and the denominator is total revenue ($20), the resulting percentage would be 5%. If the $1 is used in the numerator and the denominator excludes advertising revenue (*i.e.*, is $19), the resulting percentage would be 5.26%. Applying the 5% rate to total revenue yields the expected result – $1. Applying the 5.26% rate to subscription revenue only ($19) also yields the expected result – $1. However, applying the 5.26% result to total revenue ($20) yields – $1.052, a result in excess of the net cost of non-music programming. That result is, of course, inconsistent with SoundExchange's theory; it is wrong. SDARS PFF ¶¶ 814, 821-22, 845-849.

367. SoundExchange argues that "by subtracting revenues from the cost of non-music programming, [Professor Benston] radically shrinks the numerator of his calculations and skews any calculations of the overall percentage of revenue significantly." SX PFF ¶ 586. But it is SoundExchange's failure to subtract the offsetting benefit to the services, before determining the net cost of the non-music programming, that radically skews the result. In the example above, SoundExchange would not subtract advertising revenues from the numerator, leaving a resulting fraction of $2/$20 or 10%. Applied to $20 in total revenues would yield a cost of non-music programming of $2. In other words, SoundExchange would have the service pay music

programming $2 when its actual cost for non-music programming is just $1. That is not the equality that Dr. Pelcovits posits in his testimony. *See* Pelcovits AWDT at 9 (costs of music programming ought to be the same as the cost of non-music programming).

368. SoundExchange also presents an example, which it claims yields "absurd results." SX PFF ¶ 585. In fact, the only thing that is absurd is the example. The alleged paradox that SoundExchange recites is that Professor Benston's analysis would result in a net non-music programming expense of zero when the non-music content provider was paid $10 million. But that is no paradox: the actual incremental cost to the hypothetical satellite radio service from the agreement with the content provider (in the SoundExchange hypothetical)is, in fact, $0. The fact that the advertising revenue flows to the content provider does not change that fact.

369. SoundExchange does not mention that once he had an opportunity to consider the hypothetical, Professor Benston explained the situation precisely: "We're not talking about how much [the content provider is] getting, we're talking about how much the company is paying, it's costing them zero." 8/20/07 Tr. 162:4-9 (Benston). Mr. Handzo then told the witness "Let's talk about what the content provider is getting paid, because I think that's actually what my clients are interested in." *Id.* 162:13-16. But while that may be what Mr. Handzo was interested in while cross-examining Professor Benston, Dr. Pelcovits' theory requires consideration of the cost to the SDARS, not of receipts by the content providers. The alleged profit-maximizing/cost-minimizing producer is selecting inputs not to minimize the aggregate receipts by the inputs but to minimize the costs to the producer. *See supra* Part V.A.1.

370. Of course, SoundExchange's hypothetical bears no resemblance to reality. An SDARS would not enter into an agreement for no benefit, as proposed by the hypothetical. But, taking the hypothetical on its own terms, it actually yields precisely the result that should be

expected: a hypothetical SDARS would not pay more than $0 for music programming that generates no advertising revenues and no subscription revenues.

371. In fact, Dr. Pelcovits mishandled advertising revenue in two ways. In computing the payments to non-music content providers, Dr. Pelcovits included the content provider's advertising revenue share as a cost to the SDARS. *See* Pelcovits AWDT at 9 (adding XM's advertising revenue share to content providers); *Id.* at 10 (starting with Sirius' "Expense for programming and content," which includes the content provider's ad revenue share for accounting purposes, *see* SIR Trial Ex. 47 at F-10 (2006 10-k showing that "Advertising revenue share payments are recorded to programming and content expense during the period in which the advertising is broadcast.")). Properly viewed, the content providers' advertising revenue share is not an incremental cost of the non-music content to the SDARS; it is money that the SDARS would not have had absent the programming. In other words, evaluation of the true incremental cost of the non-music content to the SDARS would require deduction from "non-music programming costs" of the full amount of advertising revenue, regardless of whether retained by the SDARS or paid to the content provider.

### 3. The Correct Years To Analyze Are 2007-2012.

372. SoundExchange's criticism of Professor Benston for failing to include the earlier years of the non-music content agreements misses the mark. The SoundExchange model posits that the SDARS should be willing to pay the same amount for music programming as they pay for non-music programming. If that (misguided) theory is to have any meaning, it must mean that the SDARS should be willing to pay the same amount for music programming as they will pay for non-music programming over the license term. The years before the license term are not at issue here. SoundExchange offers no rationale for Dr. Pelcovits' use of the year before the license term as the basis of his fee model.

373. SoundExchange admits that "as a general matter, non-music content costs as a percentage of revenue decline over time." SX PFF ¶ 587. However, it accuses Professor Benston of doing "precisely what Dr. Pelcovits did, except in reverse." *Id.* In fact, Professor Benston did not commit the same error as Dr. Pelcovits for the simple reason that Professor Benston analyzed the entire license period. Dr. Pelcovits did not analyze even a single year in the license period, selecting instead the highly biased year before the license term.

374. SoundExchange claims that Professor Benston was wrong because he did not analyze the earlier years of the non-music content deals. But SoundExchange admits that in those years the SDARS were investing in subscribers for later years. *See* SX PFF ¶ 540. It is no more appropriate to include 2006 in this analysis than it is to include 2013, the year after the license term.

#### 4. Properly Performed, the Benston Analysis Including Stern Costs Results in a Sound Recording Fee in the Range Proposed by SDARS

375. Professor Benston's analysis of the non-Stern, non-music programming costs over the correct years, offsetting the SDARS' advertising revenues, is a far more relevant analysis than Dr. Pelcovits' examination of 2006. The outcome of that analysis is discussed in the SDARS' PFF at Part VII.D.3.c.

376. As discussed above, SoundExchange's criticism of Professor Benston's exclusion of Stern contract costs in the relevant years is misplaced. But even if the annual costs of the Stern contract are included in the Benston analysis, and SDARS' advertising revenues are treated properly by offsetting them against contract costs, the result of the non-music programming model remains near the range proposed by the SDARS and does not begin to approach the fees proposed by SoundExchange.

377. It is a simple matter to perform the Benston re-analysis of non-music programming with the Stern programming costs and offsetting advertising revenues included from data in the record. *Cf.* SX PFF ¶ 588 ("it is a matter of simple math to take the numbers in Professor Benston's charts and recalculate them to correct the errors outlined above.").

**Correction of Dr. Pelcovits' Non-Music Benchmark for Sirius Including Stern**[37]

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | *($ millions)* | | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| 1 | Total Revenue | | [[ | | | | | |
| 2 | Non-music Programming Expense | | | | | | | |
| 3 | Add Non-music Prog. Equity Expense | | | | | | | |
| 4 | Non-music Programming Expense | | | | | | | |
| 5 | Advertising Revenue | | | | | | | |
| 6 | Deduct Ad Revenue Share | | | | | | | |
| 7 | Deduct Ad Commissions | | | | | | | |
| 8 | Deduct G&A Advertising Expense | | | | | | | |
| 9 | Net Non-music Advertising Revenue | | | | | | | |
| 10 | Net Non-music Programming Expense | | | | | | | |
| 11 | Deduct Musical Works Royalty | | | | | | | |
| 12 | Deduct Music Programming Expense | | | | | | | |
| 13 | Deduct Music Prog. Equity Expense | | | | | | | |
| 14 | Adjusted Pelcovits' Benchmark Net Non-Music Programming Expense Including Stern | | | | | | | |
| 15 | As a % of Revenue | | | | | | | |
| | **Average weighted by total revenue** | | ]] | | | | | |

37 The data on this table are taken from Benston Table 1A, SDARS Ex. 74, and have as their source SIR Ex. 58 (rows 1, 2, 3, 11, 12, 13) , except for (i) those rows that result from arithmetic operations on prior rows (rows 4, 9, 10, 14, 15), (ii) rows 5, 6, and 7, which have been changed to include Stern, and which are directly from SIR Ex. 58, and (iii) row 8, which is increased from the corresponding value in Benston 1A in proportion to the increase in Advertising Revenue (row 5).

378. For Sirius, the revised analysis results in a weighted average far below the rates proposed by SoundExchange or presented by Dr. Pelcovits – roughly [[ ]] of Sirius revenue. Averaging this number with XM's [[ ]], Benston WRT at Table 1B, leads to a combined revenue-weighted average of [[ ]].[38]

379. It also is worth noting that in 2012, the year Dr. Pelcovits declared most relevant for his surplus/Shapley analysis, the non-music programming analysis in Appendix A results in an implied sound recording license fee of [[ ]] of revenue for Sirius, even including the expected costs of Stern. Combined with XM's [[ ]] in 2012 results in a revenue-weighted average of [[ ]].

380. It also is possible to demonstrate the substantial effect of the value of exclusivity, brand and trademark exploitation rights, and promotion and endorsement obligations, on the non-music programming analysis using the Stern agreement as an example. Messrs. Martin and Parr valued the highest (most conservative) estimate of the non-exclusive content license value of the Stern agreement to be [[ ]] of the contract costs. SDARS PFF ¶ 1080. The following table reflects a reduction in the Stern non-music programming expense of [[ ]], representing the value attributable to these other benefits. The resulting benchmark percentage of revenue is [[ ]] for Sirius. The resulting weighted average for XM and Sirius combined is [[ ]].

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38 The combined weighted average is obtained by taking the sum of the net non-music programming expense for all years for both companies and dividing by the sum of total revenue for all years for both companies. 8/20/07 Tr. 129:12-20 (Benston); accord SX PFF Â¶ 588 n.28.

**Correction of Dr. Pelcovits' Non-Music Benchmark for Sirius Including Stern Less Conservative End of Brand/Endorsement/Exclusivity Costs per Martin/Parr**

| *($ millions)* | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Total Revenue | [[ | | | | | |
| Non-music Programming Expense incl. Stern | | | | | | |
| Add Non-music Prog. Equity Expense | | | | | | |
| Deduct Howard Stern Non Content License Costs | | | | | | |
| Non-music Programming Expense | | | | | | |
| Advertising Revenue | | | | | | |
| Deduct Ad Revenue Share | | | | | | |
| Deduct Ad Commissions | | | | | | |
| Deduct G&A Advertising Expense | | | | | | |
| Net Non-music Advertising Revenue | | | | | | |
| Net Non-music Programming Expense | | | | | | |
| Deduct Musical Works Royalty | | | | | | |
| Deduct Music Programming Expense | | | | | | |
| Deduct Music Prog. Equity Expense | | | | | | |
| Adjusted Pelcovits' Benchmark Net Non-Music Programming Expense | | | | | | |
| As a % of Revenue | | | | | | |
| **Average weighted by total revenue** | ]] | | | | | |

### 5. SoundExchange's Attempt To Recalculate the Benston Analysis Repeats the Flaws of Dr. Pelcovits' Original Analysis.

381. SoundExchange purports to perform its own reanalysis of the Benston analysis, *see* SX PFF ¶ 588, but it carries forward the errors made in the original. First, SoundExchange fails to evaluate the net incremental cost of the non-music agreements by once again refusing to subtract advertising revenues. It compounds the error by adding the content provider's ad

revenue share, which, as discussed above, is not an incremental cost to the SDARS of the programming. *Id.*

382. Second, SoundExchange continues its error of including 2006 in its weighted average. SoundExchange's tables thus include seven years, not the six years of the license term. In other words, although it says it bases its model on the concept that music programming should be paid the same as non-music programming, SoundExchange rigs its model so that, over the license term, music programming would be paid substantially more than non-music programming by artificially inflating the percentage of revenue paid to non-music programming with the demonstrably overstated 2006 percentage. *Id.* at Figure 27. There is no more justification for including 2006 in the reanalysis than there was for Dr. Pelcovits' highly biased original analysis of only 2006.

383. Finally, SoundExchange further ups the result by changing Dr. Pelcovits' original proposition that music programming should be paid the same as non-music programming and instead applying Professor Wind's 56% "willingness-to-pay" number for music and assuming that means that non-music programming produces just 44% of the revenue. *See id.* The Wind 56% number is greatly overstated, for all of the reasons discussed elsewhere. *See* SDARS PFF ¶¶ 905-949.

384. But the calculation is just another illustration of SoundExchange's willingness to play numbers games. In its Shapley discussion, SoundExchange admits that it is necessary to normalize the willingness-to-pay number derived by Professor Wind for music with the willingness-to-pay numbers derived for non-music content, because the total exceeds 100%. *Id.* ¶ 741. In the Shapley discussion, SoundExchange admits that the normalized value of music programming, as determined by Professor Wind, is 43% of overall content value, not 56%.

Thus, the application of the relative values of content determined by the Wind study would significantly reduce the resulting implied sound recording fee, not increase it.

### C. SoundExchange's Attempt To Justify Its Stern Benchmark Suffers from the Same Defects as its Non-Music Programming Benchmark and Distorts the Significance of Sirius' Internal Surveys.

385. The defects in SoundExchange's Stern benchmark analysis are mostly addressed in the SDARS' Proposed Findings and Conclusions, *see* SDARS PFF ¶¶ 905. 947, 1029-1037, 1080, 1097, and in Part V.A., above. Only a relative few points require further response.

386. First, SoundExchange makes the same basic mistake in determining the "Total Stern Compensation," SX PFF ¶ 554, as it makes in its non-music programming analysis. It focuses on the revenues to Stern rather than on the costs to Sirius. That is not consistent with the economic theory on which it purports to rely. *See supra* Parts V.A.1 & B.2. The advertising revenue share paid to Howard Stern is not a cost to Sirius and should not have been considered in the numerator of the analysis. On the other hand, Sirius' advertising revenues are a direct offset to the cost of the Stern agreement and should have been deducted. *Id.* These errors affect Dr. Pelcovits' analysis by approximately $100 million in the aggregate, even in his 2 million subscriber case. Pelcovits AWDT, Appendix A.

387. As discussed above, Dr. Pelcovits ignores the additional rights granted by the Stern deal, including the right to exploit the Stern brand and trademarks and Stern's direct endorsement and promotion of Sirius. *See supra* Part V.A.2. It also ignores the enormous benefits the Stern deal provided in immediate publicity and credibility. Even the analyst reports that Dr. Pelcovits relies upon recognize these benefits. According to Kagan: "At the time of the announcement, Sirius was trailing XM in every key category and was looked upon as the weaker of the two satellite services by Wall Street. The Stern deal changed that, as Sirius' newfound inside track to Stern's estimated eight mil. - 12 mil. listeners gave it a greater degree of

legitimacy on Wall Street, which in turn positively impacted its automotive and retail partnerships." Pelcovits AWDT, Appendix A. As stated in the earnings call at the time of the Stern deal, "As you might imagine, there will be significant promotional opportunities that will help build Sirius brand awareness, grow subscribers, and generate enormous press coverage. And we can do this through public appearances, consumer offers like promotional giveaways in stores, and public relations." SX Ex. 144 DR at SIR0028532.

388. SoundExchange's attempt to defend Dr. Pelcovits' undercounting of the subscribers drawn to Sirius by the Stern deal also are misguided. SoundExchange's argument that "Sirius representatives stated that the company's research supported the proposition that Stern would bring one million subscribers to Sirius," (SX PFF ¶ 556, (citing Pelcovits AWDT at 6-7, SX Ex. 144 DR)), distorts that statement. The context makes clear that Sirius calculated that it merely would recoup its investment with one million Howard Stern-generated subscribers. *Id.* at SIR 0028531; SX PFF ¶¶ 552, 558; (Pelcovits AWDT at 6-7, n. 13, 14 (citing Deposition of Mel Karmazin, Docket No. 2006-1 CRB DSTRA at 84:19-85:4, 91:4-91:9, 95:2-95:12 (May 2, 2007) ("Karmazin Dep.").) *See also* 6/12/07 Tr. 158:20-160:11 (Frear) ("It's fair to say that we concluded that was the break-even level."). SoundExchange twice cites the number of subscribers Sirius believed were "needed . . . to break even." SX PFF ¶¶ 556, 558. SoundExchange even argues that Sirius would have been willing to enter into the deal with that level of incremental subscribers. SX PFF ¶ 558. But that argument simply confirms the extraordinary benefits that the deal provided other than subscribers drawn from Stern's fan base. The only reason to do a deal at "break even" subscriber increments is if it provides other valuable benefits. As the Kagan report relied upon by Dr. Pelcovits declared, the Stern deal was a "watershed moment for the company." SDARS Ex. 67 at 2.

389. The record evidence indicates that Sirius expected a much higher subscriber draw from the base of Stern fans than the overly conservative estimates used by Dr. Pelcovits. The Kagan report cites a study supposedly relied upon by Sirius finding that 30% of Stern's terrestrial radio fans indicated they would be "very likely" to sign up for Sirius, and states that Sirius estimated Stern's terrestrial radio fan base to be about 12 million people. 30% of 12 million people is 3.6 million people. In fact, a study by Odyssey states that [[

]] SX Trial Ex. 83 at SIR00023215. The study further found that [[

]], and, of these fans, [[

]] *id.* at SIR 00023218-19.

390. SoundExchange attempts to rely on certain study reports commissioned by Sirius to bolster its contention that the Stern deal was not expected to result in substantial benefits. *See* SX PFF ¶¶ 559, 566-69. But these reports actually support Sirius' testimony that it expected Stern to draw many millions of subscribers.

391. As a threshold matter, these reports were introduced with no sponsoring witness and no discussion of their significance to Sirius, use by Sirius, or how they were conducted. They were introduced solely to impeach Dr. Joachimsthaler, who testified that he had not seen them and did not know what they represented or how they were used by Sirius. SoundExchange had multiple opportunities to question Sirius executives about these documents but elected not to do so. Under the rules, these reports are not properly in evidence for any purpose other than impeachment of Dr. Joachimsthaler. Rule 359.1(b) states that parties must exchange all exhibits

at least one day prior to offer, unless, in accordance with Rule 351.10(g), the party offers the exhibit solely for purposes of impeachment.

392. Reading behind the conclusory statements by the consultants, the Odyssey study of non-satellite subscribers found that [[ ]] were more likely to buy or subscribe to satellite radio if Howard Stern (completely uncensored) were available only on satellite radio. SX Trial Ex. 83 at 31. Odyssey also found that the exclusive availability of Howard Stern [[

]] *Id.* at 32. Looking only at the 11.6 million Howard Stern "fans," Odyssey projected Sirius [[ ]] would be more likely to subscribe if Howard Stern were only availably on satellite radio. Moreover, the Odyssey report nowhere accounts for the fact that Mr. Stern had made clear he was leaving terrestrial radio. If XM signed him, Sirius would have lost not only the opportunity to gain the [[ ]] Odyssey indicated had not previously considered subscribing but also the [[ ]] Odyssey reported were already very likely to subscribe to satellite radio and who would have subscribed to XM. *See* Frear WRT ¶ 21; SX Trial Ex. 83 at 35.

393. The D/R Added Value report, SX Trial Ex. 84, properly construed, supports a similar result. That study reported that [[ ]] of frequent Stern listeners would move with him to Sirius. SX Trial Ex. 84 at 9. Applying this number to the [[ ]] frequent listener number found by the Odyssey study, meant that [[ ]] of Stern's terrestrial radio listeners who had not already subscribed by October 2005 were likely to subscribe to Sirius. The study also confirmed the significance of Stern to Sirius' brand awareness. Nearly [[ ]] of target subscribers knew that Howard Stern would be joining Sirius

in January 2006. SX Trial Ex. at 84. Sirius' brand awareness, which had been far outpaced by XM's awareness prior to Stern ([[ ]]), [[ ]] within months after the Stern announcement in October 2004. *Id.* at 39. The finding that consumers believe that XM and Sirius [[ ]], SX PFF ¶ 569, simply reflects the fact that the study was conducted almost three months before Stern debuted on Sirius. In addition, the study was conducted prior to the media blitz during the 2005 holiday period. 6/12/07 Tr. 17:13-19 (Frear).

394. The Ipsos-Vantis study was conducted nine months prior to Stern's first broadcast, and purported to predict the number if "incremental" Stern subscribers that would come to Sirius through the end of 2006. SX Trial Ex. 82. Because SoundExchange introduced this document for impeachment purposes and never questioned any Sirius witness about its contents, there was no testimony from a sponsoring witness explaining how Ipsos-Vantis estimated the projected number of incremental Stern additions Sirius would obtain in each quarter. Those numbers varied from 5% to 20% of the projected net added subscribers, despite a note referencing a Sirius study from March 2005 that reported 23% of people who subscribed in the prior six months signed up because of Howard Stern. *Id.* at 9. Given the internal inconsistency in this document and the lack of any sponsoring testimony explaining the methodology, there is no basis for giving any weight to these unexplained figures. In any event, the study predicted that in addition to the "incremental" Stern subscribers that would come to Sirius, 44% of new "baseline" subscribers would be Stern listeners. *Id.* at 9. Thus, according to this study, Sirius might have lost up to 52.09% of its potential subscriber base to XM in Q205

through Q406 alone (or over 2 million subscribers based on the Ipsos-Vantis end-of-year estimates) if Stern had instead signed with XM.[39]

395. More directly, Sirius' CEO Mel Karmazin stated at the time of the deal that Stern fans numbered in excess of 12 million, (Karmazin WRT ¶ 10)which means that "[o]nly 8% of the fan base needs to sign up and this does not count casual or curious listeners . . . and if he is only on satellite radio, purchase intent jumps to nearly 30% of his fans. This equates to nearly 4 million fans before any marketing." SX Ex. 144 DR at SIR 0028531-32. Dr. Pelcovits' dismissal of this number as an "outside estimate rather than an expression of how many Stern subscribers Sirius actually expected," SX PFF ¶ 556, is uncorroborated. In fact, it is no coincidence that these numbers match up with the numbers cited in the Odyssey and Kagan reports, which Dr. Pelcovits ignores in order to inflate his benchmark ratio.

396. SoundExchange's attempt to compare the Stern deal with XM's Major League Baseball deal, SDARS PFF ¶¶ 1034-35, ignores the fact that the MLB deal covers 11 years, the Stern deal 5. SX PFF ¶ 565. The Stern deal is by far the most expensive entered into by either of the SDARS on an annual basis. *See* Martin/Parr WRT at Exs. 7-14 (calculating net present value of major content deals). In fact, Kagan questioned whether Sirius "paid too much for Howard Stern." SDARS Trial Ex. 67 at 2.[40]

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[39] Using the Ipsos-Vantis numbers, [[ ]] of the [[ ]] plus the [[ ]] equals [[ ]] in Q205, [[ ]] in Q305, [[ ]] in Q405, [[ ]] in Q106, [[ ]] in Q206, [[ ]] in Q306, [[ ]] in Q406, for a total of [[ ]]. SX Trial Ex. 84 at 9.

[40] SoundExchange's quotation of Dr. Pelcovits comparing Stern to "the music catalogue of a major record company such as Universal or SONY," SX PFF ¶ 565, only highlights the fact that Professor Wind, in asking his "willingness to pay" question that forms the basis of the Stern analysis, did not inquire about the value of the "catalog of a major record company." *See* SDARS PFF ¶¶ 905-919.

397. SoundExchange's math also distorts the results of Dr. Pelcovits' review of the Oprah Winfrey deal, which SoundExchange claims "gave Dr. Pelcovits further confidence in the Stern analysis." If, as SoundExchange claims, [[

]] the corresponding royalty for sound recordings, applying Dr. Pelcovits' Stern analysis, would have been no more than [[ ]] not [[ ]] as SoundExchange asserts. SX PFF ¶ 564.[41]

398. Finally, SoundExchange distorts Professor Noll's response to the questions raised about the opportunity cost of the Stern deal. *See* SX PFF ¶¶ 570-71. Professor Noll made clear that he believed Mr. Schneider's reliance on a six year-old agreement to be an "apples and oranges comparison" that was "not the method that you would use to estimate what his opportunity cost was." 8/16/07 Tr. 207:1-16 (Noll).

### D. The Ordover Music Agreements Should Be Rejected as Benchmarks.

399. The defense of Professor Ordover's digital music service benchmark mounted by SoundExchange in its Proposed Findings of Fact is unconvincing at best. The general recitation of the reasons why the rates paid by other music services are good benchmarks for the license at issue here, *see* SX PFF ¶¶ 589-93, does not account for the myriad unadjusted differences between the benchmark and target markets, and Professor Ordover's failure to establish that those rates are representative of the benchmark market. In their Proposed Findings of Fact, the SDARS demonstrated that Professor Ordover's music service benchmarks fail on each of these counts.

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[41] If Ms. Winfrey received [[ ]] of incremental revenues, the Pelcovits Stern analysis would next apply the Wind 56%, yielding a "music" total of [[ ]]. After subtracting [[ ]] for musical works and other music expenses, the resulting sound recording fee would be [[ ]], far from consistent with the Stern analysis. This of course, ignores all of the other flaws of the analysis.

400. Specifically, Professor Ordover failed to account or adjust for the fact that, compared to the SDARS, his selected music benchmarks:

- involve different rights (such as reproduction and distribution of copies) and, in some cases, different types of copyrighted works altogether (such as videos), *see* SDARS PFF ¶¶ 1257-60;
- involve services with different functionalities, including on-demand access to sound recordings or videos, *see* SDARS PFF ¶¶ 1261-64;
- involve services with different cost structures – most notably because "they are distributed through existing telecommunications networks to which consumers separately subscribe (high-speed Internet access or cellular phone networks) to devices that the consumer has separately purchased for other reasons and without subsidization (personal computers and cell phones), *see* SDARS PFF ¶¶ 1265-69;
- involve services that are not governed by the 801(b)(1) rate-setting standard, *see* SDARS PFF ¶¶ 1270-71.
- are drawn from upstart services in an unstable market with few subscribers (many multiples fewer than Dr. Woodbury's PSS benchmark) and unstable pricing, *see* SDARS PFF ¶¶ 1279-81.

401. The SDARS also demonstrated Professor Ordover's complete failure to even allege, let alone ensure that the rates he presented (second-hand from the cherry-picked samples in the testimony of Mr. Eisenberg and Mr. Kenswil) were in fact representative of industry-wide norms – and pointed out several recent examples of negotiated rates directly at odds with those presented by Professor Ordover. *See* SDARS PFF ¶¶ 1272-78.

402. Absent adjustments for these many differences, the lengthy catalogue of rates obtained by Sony BMG and UMG, *see* SX PFF ¶¶ 600-619 – and Professor Ordover's somewhat strained attempt to demonstrate that they "cluster" between [[ ]] of revenue, SX PFF ¶¶ 620-23 – provides no indication of the rates that should be paid by the SDARS, who offer noninteractive public performances of sound recordings through dedicated end-to-end distribution systems that cost literally billions of dollars. *See* SDARS PFF ¶ 1266.

403. This conclusion is not affected by the observation – breathlessly reported by SoundExchange – that the SDARS have indicated in their merger-related filings that they encounter competition from iPods, Internet radio, MP3 players, and the like and that the relevant market for antitrust purposes should include those competitors. SX PFF ¶¶ 595-96. First, that two services compete with another does not indicate that their sound-recording royalties should be identical – particularly when the royalty rate for one service is set under the policy guidelines of section 801(b)(1). The goal of that statute is not to ensure rate parity between the SDARS and other (non-regulated) services that pay free-market rates.

404. More importantly, the FCC filing quoted so enthusiastically by SoundExchange makes clear that the biggest competitor to the SDARS is terrestrial radio, and that the SDARS' internal studies show that the primary substitution in listening patterns caused by the SDARS is from terrestrial radio, not other music platforms. *See* SX Ex. 106 at 38-47 (listing "terrestrial radio" as the first of the products and services that compete with satellite radio, noting that "there has been substantial substitution from satellite radio to terrestrial radio," and setting out nine pages of evidence that the primary competitor of satellite radio is terrestrial radio). If the rate for the SDARS is increased, SoundExchange's own argument that products in the same market will cannibalize one another, *see* SX PFF ¶¶ 670-71, dictates that the result will be increased substitution away from the SDARS, not to higher-paying services like iTunes, but to terrestrial radio, which pays no sound recording royalty at all.

405. In any event, without actual evidence of the demand elasticities of the different services or the cross-elasticities between them (*i.e.*, the degree to which consumers will actually switch in response to price increases) and without empirical evidence comparing substitution away from higher-paying services to the SDARS with substitution from lower-paying terrestrial

radio to the SDARS, it is impossible to draw meaningful conclusions from the simple observation that the SDARS compete in the marketplace with these other services.

### 1. Professor Ordover's Adjusted Per-Subscriber Rate Is Fatally Flawed.

406. The SDARS' Proposed Findings of Fact also discussed at length the many flaws of Professor Ordover's attempt to adjust the "per-subscriber" fees from interactive (on-demand) subscription services, including:

- failing to adjust for cost differences between the benchmark and target services, as described above, *see* SDARS PFF ¶ 1285;
- starting with benchmark rates from portable interactive subscription services, despite repeated concessions by SoundExchange witnesses that the SDARS are mobile, not portable, *see* SDARS PFF ¶¶ 1296-98;
- applying an adjustment for "immediacy" for which marketplace evidence (by his own admission) had completely evaporated, *see* SDARS PFF ¶¶ 1294-95;
- applying a 5:1 interactivity adjustment from non-analogous video services when better evidence from more recent audio agreements indicates a ratio almost twice as large (10:1), *see* SDARS PFF ¶¶ 1286-87, 1292-93; and
- attempting instead to cut the admittedly inaccurate interactivity adjustment in half by introducing an "intensity of usage" adjustment supported only by information imparted by counsel, *see* SDARS PFF ¶¶ 1288-1291.

407. SoundExchange admits – as it must – that the immediacy adjustment has disappeared. SX PFF ¶ 635.[42] In their Proposed Findings of Fact, the SDARS demonstrated that the effect of this change is to cut Professor Ordover's recommended per-subscriber fee from $2.51 to $1.40 per subscriber. SDARS PFF ¶ 1299. The SDARS also explained how Professor Ordover attempted at trial to introduce data on the relative "intensity of usage" of interactive and noninteractive video services – the effect of which would have been to halve his original

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[42] More specifically, the [[ ]] charged for over-the-air downloads by Universal and Sony BMG is dropping to [[ ]] *See* SDARS PFF ¶ 1284. Strangely, this does not prevent SoundExchange from misleadingly reiterating the [[ ]] rate for over-the-air downloads in other places. *See, e.g.*, SX PFF ¶¶ 607, 613, 616.

interactivity adjustment and salvage his rate recommendation. *Id.* ¶ 1288. Finally, the SDARS showed how Professor Ordover failed to present any data on video usage in his rebuttal testimony, failed to revise his rate proposal, and instead merely inserted a footnote reporting that he had come to "understand" that his interactivity adjustment should be halved. *Id.* ¶¶ 1289-90 (describing the source of Professor Ordover's purported knowledge concerning usage intensity as unsubstantiated representations "imparted by counsel").

408. SoundExchange has used its Proposed Findings of Fact to amend Professor Ordover's testimony for him. *See* SX PFF ¶ 632 (describing the change to Professor Ordover's interactivity adjustment based on intensity of usage); *see also id.* ¶ 1428 at n.74 (referencing the "amendment" to Professor Ordover's testimony effected by the new adjustments). The result is a per-subscriber fee of $2.81 (as compared to the $2.51 originally recommended by Professor Ordover, and the $1.40 resulting from the evaporation of the immediacy adjustment). Of course, Professor Ordover never amended his analysis, so there are no "facts" to "find" concerning any such amendment. Moreover, SoundExchange has pointed to no more evidence to support this change than Professor Ordover did, and this post-hoc amendment should be rejected as well. The sole alleged source for this adjustment is a single line from the written direct testimony of Mr. Eisenberg indicating that noninteractive video services are used twice as intensively as interactive video services – and a reference to Professor Ordover's cryptic footnote. SX PFF ¶ 632.

409. In short, based on single statement from a representative of a single record company without any supporting data concerning a service with different functionality than the SDARS that involves a completely different copyrighted work than the license at issue here, SoundExchange literally doubles its rate recommendation, from $1.40 to $2.81. SoundExchange

has failed to provide a single piece of actual data to support Mr. Eisenberg's claim, including any indication of what video services (and how many) the statement applies to, whether the same holds true for other record companies, whether it holds true for sound recording (as opposed to video) licenses, what time periods are covered by the statement, the total revenues involved, or any other evidence that would lend this adjustment even a shred of credibility.

### 2. Converting a Percentage-of-Revenue or Per-Subscriber Benchmark Rate into a Per-Play Rate Does Not Correct the Flaws of the Ordover Approach.

410. SoundExchange's final gambit to shore up its music service benchmark is to "convert" its per-subscriber fee proposal into a per-play metric, which it claims insulates Professor Ordover from Dr. Woodbury's criticisms. SX PFF ¶¶ 642-48. Those criticisms, summarized above, include Professor Ordover's fundamental failure to adjust his interactive subscription service benchmarks – services that are distributed through the Internet to existing consumer computers – for the tremendous difference in costs between those services and the SDARS, which have spent billions of dollars to provide end-to-end delivery and service to the consumer through their proprietary satellite networks. *See* SDARS PFF ¶¶ 1265-69. As Dr. Woodbury testified, a benchmark percentage-of-revenue fee from a service with much lower costs – and hence lower revenues – must be adjusted before being applied to a target service with higher costs – and higher revenues reflecting those costs. Woodbury WRT ¶ 66 and nn.41, 42; *accord* Noll WRT at 112 (it is "fantasy to pretend that the content as a fraction of total costs would be the same" for the SDARS as it would be for the interactive subscription services). Only then can it be applied to the total revenues of the target service.

411. Notably, the need for such adjustment would apply to a per-subscriber benchmark no less than it applies to a percentage-of-revenue benchmark. A per-subscriber fee, after all, merely represents a percentage of the retail rate for the service: a $7.50 monthly per-subscriber

fee for a service retailing at $14.99 is effectively the same as charging 50% of revenue. (Mr. Eisenberg noted this phenomenon himself when he explained that Sony-BMG is generally paid by portable interactive subscription based on the per-subscriber prong of their fee arrangement, because the per-subscriber fee works out to [[ ]] of the retail price of the services. 6/18/2007 Tr. 162:2-10 (Eisenberg)). In short, to use the $7.50 per subscriber-fee taken from interactive subscription services as a benchmark for the SDARS without adjusting for the higher cost structure of the SDARS is no different than starting from a benchmark of 50% of revenue.[43]

412. SoundExchange attempts to evade the implications of this analysis – and Professor Ordover's failure to recognize it – by "converting" its fee proposal to a per-play charge and then comparing it to the SDARS' proposal. SoundExchange attempts to justify this comparison by citing to Dr. Woodbury's testimony that a valid competitive marketplace per-play rate, unlike a percentage-of-revenue or per-subscriber rate, would not need to be adjusted for differences in cost. SX PFF ¶ 644.

413. The problem with SoundExchange's approach is that it is not using a true per-play rate as its starting point. Rather, SoundExchange begins with a per-subscriber fee proposal – a proposal based in part on the unadjusted per-subscriber benchmarks developed by Professor Ordover, and then converts it to a per-play rate. *See* Pelcovits WRT at 21; SX PFF ¶ 645 ("Dr. Pelcovits converted both the SDARS rate proposal and the SoundExchange rate proposal into the equivalent of per play rates") (emphasis added); *id.* at ¶ 646 ("the SoundExchange rate proposal, expressed on a per-play basis") (emphasis added). SoundExchange thus takes a flawed benchmark – one that fails to account for the cost differences between the benchmark and target

[43] Professor Ordover does adjust (incorrectly) for interactively, but that is a different adjustment and does not disturb the point being made in the text.

services – and tries to sanitize it by converting it to a per-play fee and claiming that no such adjustments are necessary. Because the starting point was flawed by its lack of adjustment for costs, the resulting per-play translation is tainted as well.

414. The SDARS' proposal, by comparison, reflects Dr. Woodbury's adjustments to the PSS percentage-of-revenue rate he takes as his benchmark. As explained in the SDARS' Proposed Findings of Fact, Dr. Woodbury first adjusted the benchmark percentage of revenue to arrive the rate that properly could be applied to the SDARS' total revenues, and only then converted that adjusted rate into a per-Play recommendation. *See* SDARS PFF ¶¶ 820-834.

415. Although SoundExchange suggests that when "using a per-play rate from an interactive market as a benchmark and trying to adjust it for the SDARS market, there is no need to adjust for any cost differential between the two markets," SX PFF ¶ 644, that is not what SoundExchange actually does. Neither SoundExchange's original fee proposal nor its current dual-option proposal offer a true per-play rate. The first proposal contained only per-subscriber and percentage-of-revenue options. *See* SX PFF ¶¶ 1440-57 (describing the concern that the SDARS will cut their music use if a per-play metric is offered); *id.* ¶ 521 ("The per-subscriber metric provides downside protection by providing a minimum level of guaranteed compensation.") The current proposal's per-broadcast metric is simply an unadjusted conversion of those cost-driven rates. SoundExchange did not start with benchmark per-play rates and attempt to apply them to the SDARS. Rather, SoundExchange started with unadjusted per-subscriber rates, converted them to a per-play metric, and then compared those rates to the SDARS' proposed rates.[44] Not a single benchmark proffered by any SoundExchange witness

[44] SoundExchange does list, in the chart on page 247 of its Proposed Findings, the per-play rates for on-demand plays from interactive subscription services. But SoundExchange uses these per-play rates only as evidence of an alleged marketplace premium for portability in the context of criticizing Dr. Woodbury. SX PFF ¶ 645. SoundExchange does not use these

was based on a per-play rate. No evidence concerning the validity, use, or significance of any per-play rate has been adduced. It is too late for SoundExchange to create such a benchmark now.

416. SoundExchange also compares the SDARS' rate proposal to the *Webcasting II* per-play rates. But the *Webcasting II* rates were similarly based on a per-subscriber benchmark and should be adjusted for cost differences. That is, Dr. Pelcovits started with per-subscriber royalties from interactive services, adjusted for interactivity, and only then converted the resulting fee to a per-performance recommendation. While Dr. Pelcovits did not feel it was necessary in that case to adjust for cost differences between the benchmark interactive subscription services and the target noninteractive webcasters (both of whom have similar cost structure, as they distribute through the Internet to users' computers),[45] it would be quite improper to import that rate into this proceeding and apply it to the SDARS without making necessary adjustments for the very different costs and functionality of the SDARS.[46]

417. Thus, the comparison SoundExchange makes between the various per-play rates is not valid, because only Dr. Woodbury's proposal reflects the cost differences between the SDARS and the benchmark service. Those differences must be taken into account in the setting of the rate at issue here.

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interactive per-play rates as a benchmark for the actual per-subscriber rate that it recommends, and they say nothing about how noninteractive performances on the SDARS should be valued.

[45] In the Webcasting case, the benchmark and target services used essentially the same infrastructure and had the same cost structure to deliver services that differed only in interactivity. Indeed, in many cases the same companies were in the target and benchmark markets.

[46] It goes without saying that SoundExchange likewise has failed to make any attempt to compare the SDARS with the Webcasters in terms of functionality, cost structures, etc. – although it should be noted that SoundExchange has not actually proposed the *Webcasting II* rates as a benchmark or the basis for any rate proposal in this proceeding. It should also be remembered that the rates in *Webcasting II* were set under a different rate-setting standard.

418. Finally, aside from the issue of SoundExchange's failure to adjust to account for cost differences, the other problems with respect with Professor Ordover's per-subscriber benchmark discussed above also infect the "per-play analysis" as well; namely, SoundExchange's proposal (even when "expressed" on per-play basis) is still based [in part] on agreements from an unstable market, with pricing in flux, that do not reflect any adjustment for the 801(b)(1) policy factors.

### E. SoundExchange's Alternative Benchmarks Require Little Attention.

419. Each of the other three theories SoundExchange cites as benchmarks – Professor Ordover's DBS benchmark, Dr. Pelcovits' Shapley analysis benchmark and the heretofore unheard-of use of Professor Hauser's study as a benchmark – merits little attention. Two are essentially throwaways, advanced solely to create the illusion of abundant corroborating data for SoundExchange's unreasonable fee proposal. The third (Shapley) has been fully addressed in the SDARS' Proposed Findings of Fact, and SoundExchange's Proposed Findings of Fact adds nothing to it. None provides any insight into the appropriate rates to be set here.

#### 1. The Satellite Television ("DBS") Benchmark Deserves No Weight.

420. SoundExchange's discussion of the DBS benchmark adds virtually nothing to Professor Ordover's written direct testimony. *Compare* SX PFF ¶¶ 656-668 *with* Ordover WDT at 37-43. SoundExchange does not even attempt to rehabilitate Professor Ordover's admission at trial that the DBS benchmark was "for really illustrative purposes" and merely "a sanity check" and an "illustrative approach" rather than a "benchmark." 6/21/07 Tr. 138:9-14, 191:16-17, 192:2-3; (Ordover). *See generally* SDARS PFF Part VII.E.

421. SoundExchange admits that Professor Ordover puts forth the DBS benchmark for the sole purpose of determining whether his digital music services benchmarks should be adjusted to account for the vast differences in capital structures between these services and the

SDARS. SX PFF ¶ 656. But Professor Ordover admitted at trial that he "did not" "compare the cost structures of the DBS business and the satellite radio business." 6/21/2007 Tr. 272:18-273:2 (Ordover). SoundExchange simply ignores the evidence of record that demonstrates the many differences in capital and cost structure, as well as many other differences in the two industries that render DBS useless as a benchmark. *See* SDARS PFF ¶¶ 1231-40.

422. The DBS "benchmark" is thus advanced on the illogical premise that a similar percentage of revenue paid by video services for video content by DBS services somehow validates Professor Ordover's lack of adjustment to his digital music service benchmarks for the differences in cost and capital structure between those benchmark services and the SDARS. *See* SX PFF ¶ 656. But even assuming for the sake of argument what SoundExchange has not shown – *i.e.*, the similarity of capital and cost structure – there is no basis to draw any inference that a benchmark based on an industry with a similar capital structure to the target industry, but which also has too many differences to name, can be used to validate another benchmark from an industry more similar to the target but with a very different capital structure.

423. SoundExchange also highlights another fundamental flaw in Professor Ordover's methodology when it concedes that "it is necessary to adjust for the fact that both music and non-music programming are available on satellite radio." *Id.* at 660. Professor Ordover failed, in his DBS analysis, to make any such adjustment with respect to his derived "per subscriber" rate because he believed, incorrectly, that "in 2004 . . . satellite radio programming consisted almost entirely of music-based programming." *Id.* at 668. The record shows that was just wrong. By 2003, Sirius was dedicated to expanding its non-music programming efforts. Karmazin WDT ¶ 42. Thus, more than 40% of the channels offered by Sirius in 2004 were sports, news, and entertainment – not music. SIR Ex. 4-B (Sirius had 61 music and 44 non-music channels by

February 2004); *id.* Exs. 3A-D, 4-C (in 2004 Sirius had two political channels, NBA games, Major League Baseball's post-season games; National Hockey League games, NFL games and a 24/7 year–round NFL channel); Logan WDT ¶ 9 (noting XM offered 29 news, talk and entertainment channels when it launched service in 2001); Vendetti WDT Ex. 10 at 1 (in 2004, XM featured 30 news, talk and variety channels, 31 sports channels, 21 instant traffic and weather channels and 1 emergency alert channel).

### 2. SoundExchange's Proposed Findings Do Not Even Attempt To Defend Dr. Pelcovits' Shapley Analysis.

424. SoundExchange's presentation of Dr. Pelcovits' Shapley analysis is copied almost word-for-word from his written testimony. *Compare* SX PFF ¶¶ 726-48 *with* Pelcovits WDT at 14-32, Pelcovits WRT at 37-39. SoundExchange has made no attempt to address any of the flaws in the approach that the SDARS demonstrated during the trial. In their initial Proposed Findings of Fact, the SDARS addressed the flaws in the Shapley analysis in detail, demonstrating, among other things, that it is unreliably based on uncertain projections of a purported "surplus" in 2012, that it fails to accurately account for the SDARS' costs, that the Shapley value model is inappropriate in this context, and that at any rate Dr. Pelcovits misapplied it. SDARS PFF ¶¶ 950-1027. Those arguments need not be repeated here. Because SoundExchange does not appear to put enough stock into the Shapley analysis to compose an original defense of it, and because the arguments already presented by the SDARS thoroughly expose its shortcomings, the Judges should reject this benchmark.

### 3. The "Willingness to Pay" Result from Professor Hauser's Survey Is Not a Benchmark for a Royalty Rate.

425. SoundExchange takes out of context and mischaracterizes the "willingness-to-pay" result derived from Professor Hauser's surveys and argues that it somehow corroborates SoundExchange's rate proposal. Specifically, SoundExchange repeatedly asserts that Professor

Hauser's supposed estimated willingness-to-pay for "music programming" of $1.78 is "well in line" with or "entirely consistent" with the SoundExchange rate proposal (presumably because $1.78 is equivalent to approximately 13% of the $12.95 subscription rate). *See* SX PFF ¶¶ 336, 398, 452. This assertion is based on a mischaracterization of Professor Hauser's results as well as on the erroneous assumption that SoundExchange is entitled to 100% of a consumer's willingness-to-pay for "music programming" transmitted over satellite radio.

426. The first and most basic problem with SoundExchange's assertion that Professor Hauser's willingness-to-pay results are "consistent" with SoundExchange's proposed royalty rates is that Professor Hauser was not seeking to – and did not – determine an appropriate royalty rate. Rather, Professor Hauser measured a willingness to pay, which, as SoundExchange clearly recognized, is not the same thing as a royalty rate. Indeed, SoundExchange's proposed rates have never been equivalent to – or even half of – the "willingness-to-pay" results from Professor Wind's survey. Throughout the proceeding SoundExchange has advocated rates ranging from approximately 10% to 23% of revenue, whereas the willingness to pay purportedly measured by Professor Wind ($6.15) was approximately 47% of the subscription rate ($12.95). Accordingly, even SoundExchange has recognized from the outset that a consumer's willingness to pay for music programming is not equivalent to an appropriate royalty rate for SoundExchange's sound recording rights.

427. SoundExchange's use of Professor Hauser's supposed "willingness-to-pay" figure as a "benchmark" royalty rate is based on the absurd premise that SoundExchange is entitled to 100% of the amount that consumers attribute to the value of music from the 70s, 80s, 90s and today. SoundExchange, of course, is not entitled to every penny of "value" attributed to music

by consumers under any circumstances; the SDARS do not operate as not-for-profit, no-value-added gateways for consumers to purchase sound recordings offered by SoundExchange.

428. Moreover, the more appropriate number from Professor Hauser's study is $0.46, not $1.78. Professor Hauser's $1.78 "willingness-to-pay" measure cited by SoundExchange does not account for any of the features measured in Professor Hauser's Internet survey, other than commercial-free music and music released prior to 1970. More specifically, the "willingness-to-pay" result does not take into account, at a minimum, the other features measured in Professor Hauser's Internet survey: (1) that the artist and song are displayed on the satellite radio device; (2) the selection and sequencing of the songs by the services; (3) that the music is uncensored; (4) commentary by the DJ's and celebrity hosts; or (5) live performances. *See* Hauser WRT at Ex. M. Each of these features received importance ranking by consumers that must be credited to the SDARS, not to SoundExchange, and none of them is factored into the $1.78 willingness-to-pay result. When all of these additional features are considered, as they would have to be in determining an appropriate royalty rate, the willingness to pay for music resulting from Professor Hauser's survey is $0.46 (approximately 3.5% of the $12.95 subscription price), not $1.78. *See id.* at ¶ 107. Of course, even this estimate is a "willingness-to-pay" measure, not a measure of an appropriate royalty. SoundExchange's treatment of it as the latter simply misrepresents the purpose and results of Professor Hauser's work.[47]

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[47] In addition, there is another, more subtle, distinction between Professor Hauser's "willingness-to-pay" result and a proper royalty rate. The $1.78 "willingness-to-pay" figure cited by SoundExchange is based on averaging results from removing music at all points – from removing it first and asking what consumers would pay to removing it last, after each of the other features and types of content have been removed. Thus, by definition, the $1.78 figure includes values ascribed to music by consumers when factors such as CD-quality sound, nationwide reception, and commercial free were all still part of the service offering that the consumers were valuing. If one were truly seeking to isolate the value of the sound recording right itself, then the only relevant measure would be the value ascribed to music after each of these other features already has been removed. Put another way, when consumers value the "music" being removed when it is commercial-free, available nationwide, and of CD-quality,

429. Furthermore, SoundExchange's attempt to use the $1.78 willingness-to-pay result from Professor Hauser's survey as a royalty rate ignores the fact that a survey could not practically account for all features of satellite radio. As Professor Hauser explained, it was simply not feasible to do so within the structures of a survey, so his willingness-to-pay estimates are overstated as a result. *See id.* at ¶ 96.

430. Last, Professor Hauser did not, by design, correct the "all-or-nothing" flaw identified by Professor Noll. *See* SDARS PFF ¶¶ 934-36. Therefore, like Professor Wind's survey, Professor Hauser's willingness-to-pay determinations similarly overvalue "music" relative to other content.

431. For all of the forgoing reasons, the $1.78 "willingness-to-pay" result from Professor Hauser's survey is not, was never intended to be, and cannot be used as a "benchmark" royalty rate. SoundExchange's characterization of the number as "consistent" with SoundExchange's royalty rates is disingenuous at best.

## VI. SOUNDEXCHANGE'S FEE PROPOSAL IS UNREASONABLE, ARBITRARY, AND WOULD LEAD TO PERVERSE RESULTS

432. SoundExchange offers two fee proposals – a fee based on the greater percentage of revenue or a mostly-higher per subscriber rate ("Option A") and a hastily packaged and virtually unsupported "tiered" per-play fee ("Option B") which purportedly seeks to solve an alleged problem with the SDARS' per-play proposal, despite the fact that no such problem was proven to exist. *See* SoundExchange's Third Amended Fee Proposal § 38_.3; SX PFF ¶¶ 1415-29. Neither Option is valid, even putting aside the confiscatory fee levels sought by

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that value by definition takes into account features not attributable to the sound recording performance right.

SoundExchange, which are addressed throughout the SDARS' Proposed Findings of Fact and Conclusions of Law.

433. The Option A percentage-of-revenue/per-subscriber fee metric seeks to tax the SDARS for value that SoundExchange's copyrights do not contribute, is wholly divorced from the value of the licensed rights, and would deprive the SDARS of the right and ability to make rational business decisions to control their costs, build their services and substitute for copyrighted sound recordings if they were deemed too expensive. It fails the test of reasonableness for all of the reasons that the Judges rejected a percentage of revenue fee in the recent webcasting case. Moreover, its increasing "block rate" structure, would suck essentially all of the incremental value out of the SDARS during this license period.

434. The Option B fee proposed by SoundExchange is a proposal that was not sponsored by any witness' written testimony, was based on a misinterpretation of Sirius survey data, and selected wholly arbitrary tiers and a wholly arbitrary relationship between the fees applicable to those tiers. The "Option" is a solution in search of a problem that has not been shown to exist, and one that would cause its own distortions and would undermine the benefits of a per-play fee.

### A. A Fee Metric That Is Unrelated to Music Usage, Such As SoundExchange's Greater of Revenue or Per-Subscriber Fee in "Option A," Is Economically Less Reasonable Than One Permitting the SDARS To Pay for the Music They Use.

435. In the recent webcasting case, the Court rejected a percentage-of-revenue fee for five enumerated reasons. *See Webcasting II* at 24,089-90. As demonstrated in Part VI.A.3., below, those five reasons apply equally in this case: (i) a percentage–of-revenue fee would not charge in relation to the amount of the right that is used, *id.* at 24,089; (ii) the same complexities exist in defining taxable revenue, particularly where, as here, the services generate a significant

portion of their revenues from non-music programming, *id.*; (iii) SoundExchange's desired expansive definition of revenue "has not been shown . . . to be related to the use of the rights provided to licensees," particularly given the extensive evidence of value from other elements of the SDARS' programming, including its music programming, *id.*; (iv) the revenue-based metric will give rise to the same questions for purposes of auditing and enforcement, *id.*; and (v) the revenue based metric would "result in a situation where the Services would be forced to share revenues that are not attributable to music use, but rather to other creative or managerial inputs," *id.* at 24,090. Those precise same reasons compel rejection of the percentage of revenue fee here.

436. Moreover, the stepped fee proposed by SoundExchange in the name of avoiding disruption, is particularly insidious. As demonstrated in Part VI.B., below, the stepped fee structure would capture 100% of the benefit to the SDARS from adding subscribers between about 15 and 22 million. It would essentially eliminate any incentive for an SDARS to hire blockbuster nonmusic talent or to make substantial improvements to its service. Any benefit that might be gained would be immediately due and payable to SoundExchange. Again, SoundExchange seeks to reap where it has not sown.

### 1. A Percentage of Revenue Fee or Per Subscriber Fee Is Distortionary, Unfair and Inefficient.

437. There is near unanimity among the economic experts that the percentage-of-revenue fee (and its derivative, the per-subscriber fee) are distortionary and economically inefficient.

438. Professor Noll testified that:

> The basic point is simple: if blanket rates for all music are not related to usage, the record companies will collect the same amount of revenue regardless of the contribution of their content to subscriptions and revenues. Regardless of whether the rate is reasonable, neither record companies nor the SDARS will experience

> the appropriate financial reward based on a change in the contribution of their content to the success of satellite radio.

Noll WRT at 74.

439. Professor Noll further testified that a revenue-based or per-subscriber fee amounts to a tax on revenues that is derived from content that is not covered by the performance license, and violates the statutory criteria insofar as it:

> Generates returns to the record companies that are unrelated to their creative effort, while reducing the payments that SDARS are willing to make to support innovation by providers of other content. This outcome violates the statutory requirements regarding availability, fairness and relative contributions.

*Id.* at 77 (emphasis added). *See* 8/16/07 Tr. 152:12-153:15 (Noll) (such a fee has effects that are "inefficient and unfair");

440. 8/22/07 Tr. 193:6-11(Karmazin) (percentage-of-revenue fee "is not a fair basis . . . because there is a substantial amount of revenues that we generate that SoundExchange is not contributing toward").

441. Dr. Woodbury and Professor Ordover agreed as to the limitations of a percentage-of-revenue fee versus a per-play metric. Woodbury WRT ¶ 50; *accord* 8/23/07 Tr. 76:22-77:10 (Woodbury);. 6/21/07 Tr. 235:12-236:2 (Ordover).

### 2. A Percentage-of-Revenue or Per-Subscriber Fee Will Not Permit the SDARS To Adapt Their Business Practices in Response to Costs and Would Discourage Direct Licensing.

442. Professor Noll made clear that another serious defect in a revenue-based (or per-subscriber) fee is that it precludes the SDARS from adapting to excessive costs. "Most importantly, if the rate is excessive, the SDARS will not be able to contain the damage by reducing their use of licensed product and increasing the use of other types of content." Noll WRT at 74. He further testified that "[t]he SDARS could substitute other forms of content, including music that is not covered by the license, for post-1971 sound recordings. But SDARS

operators can mitigate the effect of a high royalty rate only if the royalty is based on actual use." *Id.* at 75.

443. Dr. Woodbury agreed: "[t]he advantage of the per play rate is that it allows the SDARS to respond like any other firm to an increase in costs." 8/23/07 Tr. 76:8-20 (Woodbury). If the rate were set too high for the liking of one of the SDARS, it could "reduce the amount of music [it's] carrying or increase the amount of live music that it's offering or it can increase the amount of directly licensed music that it's offering. Or it can increase the amount of pre-1972 music that [it's] offering in order to reduce its music cost to SoundExchange." *Id.*; *see* Woodbury WRT ¶ 49 (per-play fee "allows the SDARS to respond to any substantial increase in fees by economizing on the use of music so as to reduce their payments or otherwise pursuing direct licensing alternatives to the SoundExchange blanket license.").

444. Mr. Karmazin discussed the same issue from the standpoint of the CEO of a company facing a request for a percentage-of-revenue based fee. He testified that a percentage-of-revenue fee

> limits our ability to make rational business decisions about the right mix of music and non-music programming, about the right mix of copyrighted sound recordings and other music (such as live performances), and about the right mix of major label and independent label sound recordings. If we decide that a certain amount of music is costing us too much for the value it provides, a percentage-of-revenue based fee would not allow us to save money by cutting back on music use.

Karmazin WRT ¶ 31.

445. Mr. Karmazin further testified about the need to be able to manage sound recording fees when asked about the effect of fees at the level of SoundExchange's rate proposal: "Well, I think it would be unbelievably disruptive for us to do this, but I think what would happen, would be that we would just have to dramatically scale back on the music programming

that we offer." 6/6/07 Tr. 311:4-7 (Karmazin); *see id.* at 314:9-11 (confirming that Sirius would attempt to negotiate with individual record companies).

446. SoundExchange's proposed fee structure would also eliminate the motive for direct licensing by the SDARS. Mr. Karmazin testified that, with respect to a percentage of revenue fee, "If a record company really wants us to play its music for the promotional benefit we provide, we save nothing by obtaining the right to make the performance from that record company." Karmazin WRT ¶ 31.

447. The importance of the ability to alter programming in response to economic realities and to invest in nonmusic programming is illustrated by the SDARS' history. *See* SDARS PFF ¶¶ 73, 105-110. Had the SDARS been subject to a percentage-of-revenue or per-subscriber royalty rate, their strategy of investing heavily in non-music programming would have led to greater sound recording fees and would have penalized the SDARS for building a successful business from a failing one.

448. Even SoundExchange agrees that "there are obvious advantages to a rate proposal that incorporates [the] flexibility" to allow the SDARS "to control the amount they spend on music by increasing or decreasing the amount of music listened to on their networks." SX PFF ¶ 1430; 8/28/07 Tr. 92:22-93:7 (Pelcovits). According to SoundExchange, "all else equal it would be better if the service can cut back on music usage if it wishes to make lower payments to the record company." SX PFF ¶ 1431. Regrettably, it proposes as the SDARS' vehicle for doing so its Option B, which, as discussed in Part VI.C., below, and contrary to these statements, is calculated to ensure that SoundExchange retains a disproportionate share of the blanket fee, even if the SDARS cut back on music use or engage in direct licensing.

### 3. SoundExchange's Proposal Suffers from All of the Defects That Led this Court To Reject a Percentage of Revenue Fee in the Webcasting Case.

449. Each of the five reasons for which the Judges rejected the application of a percentage-of-revenue metric in *Webcasting II* applies just as strongly in this case, if not more so. SoundExchange claims, without substantial discussion, that "many of the reasons the Court gave in [*Webcasting II*] for rejecting a percent of revenue metric there counsel for adoption of a percent of revenue metric here," SX PFF ¶ 1418. But SoundExchange does not identify any of those reasons, other than to say that here, revenue is more easily defined, and less likely to raise audit and enforcement controversy. *See* SX PFF ¶ 1427. As discussed below, SoundExchange is wrong on both counts.

450. First, the Judges found that a percentage-of-revenue metric was inappropriate because it does not follow the basic principle that "[t]he more intensively an individual service is used and consequently the more the rights being licensed are used, the more that service [should pay] and in direct proportion to the usage." *Webcasting II* at 24,089. Dr. Pelcovits agrees: "the more the play, the more the benefit, and I believe the more should be paid by the service to the copyright holder." 8/28/07 Tr. 93:14-16 (Pelcovits); *accord* SX PFF ¶ 1433; 8/23/07 Tr. 76:8-20 (Woodbury). As discussed above, SoundExchange's preferred proposal of a percentage-of-revenue or per-subscriber metric does not vary with music use and would not allow the SDARS to adjust the royalties they would owe to SoundExchange by changing the amount of music they play. *See supra* Part VI.A.2.

451. Second, the Judges found in *Webcasting II* that "percentage-of-revenue models present measurement difficulties because identifying the relevant . . . revenues can be complex, such as where the [service] offers features unrelated to music." *Webcasting II* at 24,089. In the context of webcasting, the Judges found that "[m]ixed format webcasters/simulcasters . . . in a

number of cases, generate the more significant portion of their revenues from non-music programming." *Id.* The same problems exist here. As demonstrated in the SDARS' Proposed Findings of Fact, a significant portion of Sirius' and XM's businesses are related to activities that have nothing to do with music. *See* SDARS PFF ¶¶ 74-79, 106-111. Much of the SDARS' revenues are attributable to non-music programming, and much of the value of music programming is contributed by the SDARS and by music other than that licensed by SoundExchange (not to mention other contributions by the SDARS such as equipment design and manufacture, the establishment of sophisticated satellite delivery systems, and so forth). *See* SDARS PFF ¶¶ 211-215. The "questions surrounding the proper allocation of revenues related to music use" are every bit as acute here, if not more so. Because, as the Judges have found, only revenues related to music would be a "relevant" base for a percentage-of-revenue metric, *Webcasting II* at 24,089 (highlighting the need to identify "relevant" revenues by separating out revenues unrelated to music), SoundExchange's fee proposal presents the same problem that caused the Judges to reject such a model in *Webcasting II.*

452. Third, the Judges found that "percentage of revenue metrics ultimately demand a clear definition of revenue so as to properly relate the fee to the value of the rights being provided." *Webcasting II* at 24,089. Just as in *Webcasting II*, SoundExchange here seeks "an expansive definition of revenue, ostensibly covering revenues from subscription fees, advertisements . . . sales of products" and other revenues. *Id.* In *Webcasting II*, the Judges were "not persuaded that all the elements of the SoundExchange definition of revenue have been shown, in every instance, to be related to the use of the rights provided to licensees." *Id.* SoundExchange has made no stronger showing here. Indeed, as discussed in more detail in Part

VI.B.1., below, SoundExchange's proposed definition of revenue would include revenue earned from various activities that have nothing to do with the sound recording performance right.

453. Fourth, the Judges found in the prior proceeding that "use of a revenue-based metric gives rise to difficult questions for purposes of auditing and enforcement related to payment for the use of the license." *Webcasting II* at 24,089. Specifically, the Judges cautioned that such a metric would "give rise to additional, different issues of interpretation and controversy related to how revenues are defined or allocated." *Id.* Specifically, the Judges cited to evidence discussing the difficulties that would arise and had already arisen with SoundExchange's proposal that revenues be defined to include all revenues "paid or payable." *Id.* (citing "Radio Broadcasters PFF at ¶ 258," which discussed the Muzak audit controversy). The same evidence is in the record of this case as well. *See infra* Part VI.B.2. (discussing the Muzak audit controversy and other controversies that will arise due to SoundExchange's efforts to include within its definition of revenue both items of revenue that are in dispute between the licensee and a third party, and items of revenue that the licensee never received.) Indeed, SoundExchange has not shied away from second-guessing the calculations and records maintained by licensees – with nothing more than assumption to go on – in an attempt to increase the revenue base upon which it is paid. *See* SDARS Ex. 31 at 00204145 ([[

]]). The evidence here matches the evidence in the prior case, and there is no basis for a different holding.

454. Fifth, the Judges rejected a percentage-of-revenue metric in *Webcasting II* because it "could result in a situation where the Services would be forced to share revenues that are not attributable to music use, but rather to other creative and managerial inputs." *Webcasting*

*II* at 24,090. Just as was the case in the webcasting proceeding, the record here shows that SoundExchange's proposal would expropriate for the labels and artists the value of pieces of the SDARS' service that they did not contribute to. *See supra* Part VI.A.1.

455. In short, each of the five reasons for which the Judges rejected a revenue-based fee in *Webcasting II* apply with equal, if not greater, force here.

#### 4. SoundExchange's Per-Subscriber Fee Is Simply a Means of Hiding the Pursuit of a Higher Percentage of Revenue, and Suffers from Virtually All of the Same Defects.

456. The per-subscriber fee proposed by SoundExchange suffers from the great majority of the same defects as the percentage-of-revenue fee. The fee does not vary with music use, it charges for value not contributed by the licensed property and imposes a tax on improvements to the service and content, it does not permit the SDARS from controlling their costs, and it destroys any incentive for direct licensing.[48]

457. Nor, in the context of these services, is there any independent justification for a per-subscriber fee. SoundExchange's claim that a greater of percentage-of-revenue or per-subscriber fee "provides downside protection by providing a minimum level of guaranteed compensation," SX PFF ¶ 1416, is disingenuous at best. In fact, SoundExchange has proposed the per-subscriber fee in order to raise the effective percentage of revenue above the nominal level set forth in its fee proposal.

458. When the per-subscriber fee for the applicable subscriber level is divided by the SDARS' projected a coverage revenue per year ("ARPU"), the result exceeds the stated applicable percentage of revenue fee for virtually every year. *See* SIR Ex. 58 at 2 (showing that

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[48] In fact, the only problems it does not appear to suffer from are some of the definitional and administrative issues surrounding the concept of revenue, although it would still be necessary to establish a clear definition of "subscriber."

Sirius' ARPU for 2007-2012 is projected to grow from $10.87 to $12.01); Vendetti WRT at Ex. 4 (showing that XM's ARPU for 2007-2012 is projected to grow from $11.18 to $12.37). In other words, if ARPU levels are as expected, the "greater of" fee will be the per-subscriber fee, and the effective percentage of revenue charged by SoundExchange will exceed the levels stated in its fee proposal. For example, Mr. Butson's projected subscriber level for Sirius in 2012 is 162,208,917, resulting in a per-subscriber fee of $2.25, which is 18.7% of the projected ARPU of $12.01. That percentage is higher than the stated 17% of revenue fee that would apply.

459. In short, SoundExchange's fee proposal sets the rates to require the SDARS to increase their ARPU substantially over the license term just to avoid having to pay SoundExchange's "minimum level of guaranteed compensation." The per-subscriber minimum in fact represents an increase in the effective percentage of revenue rate, not a "minimum."

### B. The "Stepped" Structure of SoundExchange's Proposal Creates Particularly Perverse Results.

460. SoundExchange's proposed fee structure, in which the fee increases in bulk steps as the number of SDARS subscribers grow, *see* SX PFF ¶ 1413, has particularly pernicious effects beyond those inherent in the percentage-of-revenue and per-subscriber fee metrics. These effects apply both to SoundExchange's "Option A" and "Option B" (which is intended to provide the same economic result if music use remains constant, *see* SX PFF ¶ 1411). SoundExchange Third Amended Fee Proposal at 1-3, 5-7. Specifically, SoundExchange's proposed rates would increase the applicable royalty rates when each SDARS reaches subscriber thresholds of 9 million, 11 million, 13 million, 15 million, 17 million, and 19 million. *See* SX PFF ¶ 1413; SoundExchange Third Amended Fee Proposal at 1-3, 5-7. The increase triggered at each level is not simply an increase in the rate applicable to the incremental subscribers; rather, it applies to all previous subscribers. As demonstrated below, this structure unjustifiably

appropriates to SoundExchange a huge amount of the value of enhancements to the SDARS' services.

### 1. SoundExchange's Stepped Fee Proposal Would Capture for SoundExchange 100% of the Value of Every Subscriber Obtained by the SDARS Between 15 Million Subscribers and Over 20 Million Subscribers.

461. Because of the effects of SoundExchange's proposed rate structure on the SDARS' incremental costs per subscriber, the proposal would give to SoundExchange 100% of the value of every subscriber between the 15 millionth and the 20 millionth. This feature would ensure that the SDARS have no incentive whatsoever to increase their number of subscribers beyond the 15 million mark, and it would thus discourage the availability of creative works to the public that is a hallmark of the section 801(b)(1) standard.

462. As Professor Noll explained, under SoundExchange's step structure, as an SDARS crosses each subscriber threshold, its total payments jump significantly because the higher rate applies not just to incremental subscribers, but to total subscribers. *See* Noll WRT at 42. This results in huge marginal costs to the SDARS of adding the one additional subscriber that takes it across the threshold – costs that are not recouped until significantly more subscribers are added. As a result, [t]his rate structure gives the SDARS operators no incentive to add subscribers as they approach 15 million. Bring this up into the paragraph, the quote ends here" Noll WRT at 43-44. The effect of SoundExchange's proposed rate structure would be to cause the SDARS to be worse off than it was with 14,999,999 subscribers for more than half of the months it operates between 15 millionth and the 17 millionth subscriber, leading to a total net loss for entire period in which the SDARS has between 15 million and 17 million subscribers. *Id.* This is also true of the 17- to 19-million subscriber step."

463. Although Professor Noll's testimony was based on the SoundExchange fee proposal then before the Judges (the "First Amended" fee proposal), the same effect applies to SoundExchange's final "Third Amended" fee proposal. The chart below demonstrates the economic ramifications of SoundExchange's proposed rate structure as the SDARS seek to grow their subscribers. The first column shows the number of subscribers immediately preceding a fee level threshold. The second column shows the monthly cost of adding one more subscriber to the number in the first column, and thus breaking into the next step of SoundExchange's fee proposal. *See* Noll WRT at 43. This column is calculated by multiplying the total number of subscribers if one more is added (in the first row, 9,000,000) by the difference between the lower step's per-subscriber fee and the newer step's per-subscriber fee (in the first row, $0.30 – the difference between $0.85 and $1.15). *Id.* The third column represents the net operating margin per subscriber the SDARS would obtain for each subscriber it adds in the new step of SoundExchange's fee proposal. This figure is calculated by subtracting SoundExchange's per-subscriber fee for that step from the figure ($7.50) presented by Dr. Pelcovits for the average operating margin of Sirius and XM (in the first row, $7.50 - $1.15 = $6.35). *See id.* The fourth column represents the number of subscribers the SDARS will have to obtain before it is able to recoup the hit it took by crossing the prior subscriber threshold. *See* 8/16/07 Tr. 159:14-19 (Noll). That is, the SDARS will continue to be worse off <u>each month</u>, as a result of having crossed the 9 million subscriber mark until it has enough subscribers that the net gain per subscriber multiplied by the number of subscribers equals the cost in the second column. *See* Noll WRT at 43.

| Number of Subscribers | Monthly Cost of One More Subscriber | Net Gain Per Subscriber in New Interval | Break-even Number of Subscribers |
|---|---|---|---|
| 8,999,999 | $2.70 million | $6.35 | 9,425,196 |
| 10,999,999 | $3.30 million | $6.05 | 11,545,454 |
| 12,999,999 | $4.55 million | $5.70 | 13,798,245 |
| 14,999,999 | $6.75 million | $5.25 | 16,285,714 |
| 16,999,999 | $6.80 million | $4.85 | 18,402,061 |
| 18,999,999 | $6.65 million | $4.50 | 20,477,777 |

464. Moreover, to the extent that the break-even point is beyond the midpoint of the range at each level, there will likely be a residual accumulated deficit from the fee level (compared to operating in the prior level). If one assumes that the positive months will most nearly offset negative months equidistant from the midpoint, the accumulated deficit in the 15-17 million tier would roughly equal the deficit incurred during the first 471,428 subscribers in the tier, and the accumulated deficit in the 17-19 million tier would roughly equal the first 804,122 subscribers in the tier.[49]

465. In fact, once an SDARS adds its 15 millionth subscriber, it will not earn a penny of profit on any additional subscriber until its 20,477,478th subscriber. *See* Noll WRT at 43-44. Even then, it will continue to be worse off than it was at 14,999,999 subscribers until it recoups the accumulated deficit from the period when it had between 19,000,000 and 20,477,777 subscribers, as well as the accumulated deficits discussed in the prior paragraph. That is likely to take until well above 22 million or more subscribers.

[49] This number may be obtained by doubling the number of subscribers by which the break-even point exceeds the midpoint of the tier.

466. Mr. Butson's subscriber projections, the original version of which Mr. Frear testified was "vastly overoptimistic and unrealistic", Frear WRT ¶ 4, do not show either XM or Sirius reaching 20,477,478 subscribers until sometime in late 2016, and 22 million not until 2018 or 2019. Butson WRT at App. A at 3; *id.* at App. B at 4. Thus, SoundExchange's proposal would deprive the SDARS of any benefit from the time they each hit 15 million subscribers until at least that time – well past the end of the current license period, and possibly even past the end of the next license period. *See* 8/16/07 Tr. 160:10-19 (Noll).

467. This is the wrong incentive to provide for both the SDARS and for SoundExchange. Once the SDARS reach 15 million subscribers, the SDARS will have no incentive to improve their product, add new programming, or increase their revenues. *See* 8/16/07 Tr. 160:20-161:8 (Noll). That will result in stagnancy for the SDARS and reduced royalty revenue for SoundExchange. This is not the kind of fee structure envisioned by the statute, and it is not one that would work to anyone's benefit.

### 2. The Step Structure Would Discourage Future Investment in Nonmusic Programming.

468. Another unwarranted effect that would be produced by the stepped structure of SoundExchange's fee proposal is the fact that it acts as a direct disincentive to the SDARS' decisions to invest in new nonmusic programming.

469. Professor Noll offered an example that illustrates this phenomenon. Suppose an SDARS had 12,600,000 subscribers, and had the opportunity to create a new channel with a famous personality that is expected to add an additional 2,500,000 subscribers to the SDARS, such as a new Howard Stern. *See* Noll WRT at 77. Under SoundExchange's fee proposal, if the SDARS did that deal and gained the additional subscribers, it would actually cross two thresholds along the way – the 13 million subscriber threshold and the 15 million subscriber

threshold. Thus, the per-subscriber royalty would increase by 65 cents per month for the 12.6 million initial subscribers and each of the 2.5 million new subscribers would incur a royalty of $1.80 per subscriber per month. *See* SoundExchange's Third Amended Rate Proposal at §§ 38_.3(c) and (e). The resulting increase in payments to SoundExchange would be $12.69 million per month, or over $152 million per year.[50] *See* Noll WRT at 77. Such a payment to SoundExchange would be nearly [[ ]] times the annual cash compensation actually provided for in Sirius' contract with Howard Stern. SX Ex. 27 at SIR 00010466. Yet the record companies and performing artists who would receive these hundreds of millions of dollars would have contributed nothing to the improvement of the service, and the amount of music used on the service would not have changed at all.

470. Such an outcome does not comport with the section 801(b)(1) statutory guidelines that require that the rate reflect, among other things, the relative creative contribution of the parties to the product, and a fair income and fair return to the parties. An enormous windfall for SoundExchange based on no contribution of its own is not contemplated by the statute.

### C. SoundExchange's Proposed Definition of Revenue Is Unreasonable on Its Face.

#### 1. SoundExchange's Proposed Definition of Revenue Is Grossly Overbroad, Including Revenue Completely Unrelated to the Use of Sound Recordings.

471. The overbreadth and unreasonableness of SoundExchange's "Option A" rate proposal is highlighted by the breathtaking scope of its proposed definition of revenue, which includes numerous elements of revenue that have nothing at all to do with the use of the statutory

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[50] Again, the methodology in this example was laid out by Professor Noll in his Written Rebuttal Testimony. *See* Noll WRT at 77. However, the numbers used in Professor Noll's written testimony were taken from SoundExchange's First Amended Rate Proposal. Since that time, SoundExchange has submitted its Third Amended Rate Proposal, which is the basis for the numbers used in this discussion.

license. Because SoundExchange's proposed definition of revenue includes so many elements that are unrelated to the rights at issue in this proceeding, it should be rejected.

472. SoundExchange's definition of revenue only explicitly excludes revenues attributable to activities "that are entirely unrelated to the provision of preexisting satellite digital audio radio services, as defined in 17 U.S.C. § 114(j)(10)." SoundExchange's Third Amended Rate Proposal, § 38_.2(g). While we are confident SoundExchange did not intend to include them, this language, on its face, could be read to include revenue attributable to the SDARS' webcasting services, satellite television music services, or business establishment services, all of which are at least somewhat "related" to the preexisting satellite digital audio radio service, because the same entity re-broadcasts at least a portion of the same programming from the same source. Those activities are subject to the section 114 and section 112 statutory licenses under a different standard and are subject to different rate-setting proceedings, and the SDARS pay royalties to SoundExchange for those services separately. The fact that the plain meaning of the language proposed by SoundExchange is broad enough to encompass those performances illustrates the overbreadth of SoundExchange's proposed definition of revenue.

473. It is clear, however, that SoundExchange's proposed definition of revenue would include at a minimum items such as the following, none of which has anything to do with the statutory license at issue in this proceeding:

- revenue from advertising and sponsorship on the SDARS' nonmusic channels;
- revenue from the sales of satellite radio receivers and other equipment;
- revenue from transmissions made outside the United States;
- revenue from special subscriptions to premium nonmusic channels;
- royalties paid to the SDARS for the licensing of intellectual property rights;

- sales and use taxes, shipping and handling, credit card, invoice, and fulfillment service fees;
- bad debt expense;
- revenue earned through the sale of phonorecords or digital phonorecord deliveries.

The Judges found in *Webcasting II* that "a revenue-based metric should only be used as a proxy for a usage-based metric where the revenue base used for royalty calculation is carefully defined to correspond as closely as possible to the intrinsic value of the licensed property." *Webcasting II* at 24,089 (internal quotation marks omitted). SoundExchange clearly fails that test in this instance. The value of the sound recording performance right bears no relation to any of these items of revenue, so if a revenue-based metric is used, these items should be excluded from the definition of revenue.

474. SoundExchange's attempt to collect royalties from the SDARS' revenue received from advertisements run on the SDARS' non-music channels also is unreasonable, as there is no connection between this revenue and the sound recording performances on the SDARS. Royalty payments made by the SDARS to SoundExchange are for the statutory license to make public performances of sound recordings. Very few feature performances are made on any of the channels that feature advertising, and, other than the approximately five XM channels that are not programmed by XM, *see* 6/5/07 Tr. 104:20-105:9 (Logan), none of the channels that feature such performances have any advertising. Thus, including advertising revenue in the definition of revenue for a percentage-of-revenue metric would give SoundExchange payment for something unrelated to the right being licensed.

475. Likewise, it would be erroneous to include in the revenue base, for example, revenues earned from equipment sales. The SDARS largely do not recoup their costs on equipment as it is because of the subsidies offered to equipment manufacturers and the

engineering costs involved. *See* Law WDT ¶ 7; Wilsterman WDT ¶10; Parsons ¶ 19; Masiello WDT ¶ 19; 6/4/07 Tr. 325:15-327:1 (Parsons); 6/5/07 336:7-337:2 (Vendetti); 6/7/07 Tr. 167:7-13 (Wilsterman). Although the SDARS do maintain line items in their financial statements for "equipment revenue," that revenue is mostly offset by other related costs. Thus, giving SoundExchange a percentage of that revenue – revenue which, for the most part, the SDARS never even see – is wrong not only because it has nothing to do with sound recordings, but also because it is revenue never actually realized by the SDARS.

476. To the extent the SDARS maintain operations outside the United States, any performances of sound recordings occurring in such foreign venues would not be subject to the statutory license, which only covers transmissions made within the United States. For example, XM and Sirius both have revenue from Canadian relationships or subscribers. *See* 6/5/07 Tr. 345:14-18 (Vendetti); 6/7/07 Tr. 344:18-345:8 (Cohen). These foreign broadcasts are subject to royalty payments under Canadian law, and the SDARS pay those Canadian royalties. 6/12/07 Tr. 23:14-19 (Frear). They should not be subject to a royalty based on U.S. law as well.

### 2. SoundExchange's Request for Revenue "Payable" to the SDARS Is Vague and Invites Controversy.

477. Beyond the sheer overbreadth of SoundExchange's revenue definition, its desire to tax "all revenue paid or payable," SoundExchange Third Amended Rate Proposal at § 38_.2(g), makes it unworkable and ensures controversy and abuse. *See* SX PFF ¶ 1427. This provides yet another reason not to adopt a percentage of revenue fee, and, if a percentage-of-revenue metric is adopted and a definition of revenue is included in the regulations applicable to the SDARS, the definition proposed by SoundExchange should be rejected.

478. Although SoundExchange contends that its proposed definition of revenue would be "straightforward and administrable," SX PFF ¶ 1427, its definition would in fact be

cumbersome and ambiguous, and would lead to dispute after dispute between the SDARS and SoundExchange if adopted. Because SoundExchange has proposed that royalties be calculated against "payable" revenue in addition to "paid" revenue, its claim that "the necessary revenue figures here can be taken directly from the SDARS' 10-Q and 10-K forms" is simply untrue. *Id.*

479. SoundExchange has made clear that it intends its definition to include elements such as unpaid subscription fees that XM and Sirius have never received and late fees that XM and Sirius had a discretionary right to collect, but which XM and Sirius decided not to do in their business judgment. *See* 6/19/07 Tr. 62:21-64:6 (Kessler). The SDARS do not report such items in their public filings, and even if they did, the public filings are not released often enough to satisfy SoundExchange's proposed monthly payment due dates. There is no easily administrable method for determining the total amount of revenue encompassed within SoundExchange's broad definition, putting aside any concerns about the propriety of such a definition. SoundExchange's proposed method, at least, falls far short of the mark.

480. SoundExchange's past dealings with licensees paying under a percentage-of-revenue metric (even without an explicit provision that revenue includes "payable" revenue) demonstrates the kind of disputes that will inevitably arise if SoundExchange's proposal is adopted. *See* SDARS Ex. 32 at SE 00204336-37 (report of SoundExchange's 2005 audit of Muzak).

481. Indeed, SoundExchange's proposal would require licensees to investigate the nature of their contractual relationship with third parties to determine if additional royalties are owed to SoundExchange. 6/19/07 Tr. 111:19-113:2 (Kessler). In the Muzak audit,

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]]. SDARS Ex. 31 at 00204145. These tactics formed a part of the Judges' reasoning for not adopting a percentage of revenue fee in the Webcasting case. *See Webcasting II* at 24,089, (citing Radio Broadcasters) PFF ¶ 258).

### D. SoundExchange's "Option B" Is Based on Arbitrary and Misinterpreted Numbers and Provides No Guidance to the Judges Whatsoever.

482. In apparent recognition of the defects in its percentage of revenue/per-subscriber fee proposal, SoundExchange half-heartedly presented a per-play proposal as "Option B." Although "an illustration" of a tiered per-play fee was presented in Dr. Pelcovits' Written Rebuttal Testimony, that illustration was not the proposal advanced by SoundExchange.

483. The net result is an Option B proposal that lacked sponsorship by any witness' written testimony, was based on a misinterpretation of Sirius survey data, and is a wholly arbitrary solution in search of a problem that has not been shown to exist.

484. The one thing "Option B" ensures is that the ability of the SDARS to control their SoundExchange fees and to adapt their businesses will be curtailed compared to a pure per-play fee, ensuring maximum revenues for SoundExchange and limiting the potential benefits of direct licensing.

485. SoundExchange asserts, without citation and with no evidence, that under a per-play rate, the SDARS would not eliminate the most listened-to broadcasts, but would pick the least listened-to broadcasts for elimination. SX PFF ¶ 1443. That is pure speculation. SoundExchange did not ask any SDARS executive how their company would react to a per-play fee, although it had many opportunities, nor has SoundExchange made any effort to quantify any such effect if such an effect would exist.

486. SoundExchange's Proposed Findings of Fact confirm the speculative nature of the alleged problem SoundExchange seeks to cure. *See* SX PFF ¶ 1448 (asserting that "Dr. Pelcovits provided an example of what might happen. . . . He then supposed . . . [a]nd, finally he assumed . . . .")(emphasis added); *id.* at ¶ 1449 ("The same kind of result might occur. . . . Again Dr. Pelcovits assumed.") (emphasis added). None of that constitutes probative evidence.

487. SoundExchange's Option B depends on the assumption that "when the SDARS eliminate a sound recording, it is assumed to be a sound recording on a less heavily listened to station." SX PFF ¶ 1450. Of course, an SDARS is as likely to cut back the number of performances on more listened-to stations or to seek direct licenses, substitute live performances or substitute non-copyrighted performances on more popular stations. *See, e.g.*, 6/11/07 Tr. 83:21-85:1 (Blatter) (Sirius uses its music stations to attempt to reach "listeners with particular or narrow interests"); 6/6/07 Tr. 311:19-312:13 (Karmazin) (if statutorily licensed music were removed, Sirius might replace it with "a whole bunch of channels aimed at core groups"). If an SDARS reduced or directly licensed copyrighted performances on the most listened-to channels, SoundExchange's proposal would only reduce the SDARS' fee as though it had reduced the number of performances on one of the least listened-to channels. 8/28/07 Tr. 219:10-220:5 (Pelcovits).

488. SoundExchange's Option B is also based on a fundamental misconception of the data on which it purports to rely. Dr. Pelcovits used a listening index from Sirius' Listener Study as the basis for his tiered illustration, 8/28/07 Tr. 193:4-194:2 (Pelcovits); SX Trial Ex. 34, and SoundExchange used the same index to support the tiers in its Option B fee proposal. SX PFF ¶ 1452. Dr. Pelcovits testified that he used the index to represent relative time spent listening to different music channels on Sirius. Pelcovits WRT at 24; 8/28/07 Tr. 189:14-190:8 (Pelcovits).

SoundExchange based its Option B on the assumption that the index allowed it to determine the top and bottom "half of the listens" and the "most popular songs" and "least popular songs." SX PFF ¶1452; *see id.* at ¶1446 (index shows "variation in listening" and index represents "percentage of listening").

489. In fact, SoundExchange and Dr. Pelcovits both misconstrued the Sirius index. It did not represent either time spent listening, percentage of listening, or the "most popular songs," in either an absolute or relative way; rather, it asked respondents whether they listened to a particular channel for at least five minutes in the prior week. SX Trial Ex. 112 DR at 45 (SIR00025651), 53 (SIR00025659) (showing that the data measure number of people who listened in the past week) SX Ex. 34 at 11 (indicating that the data measure "past week and yesterday listening"); 8/28/07 Tr. 196:19-197:3 (Pelcovits); *see also id.* at 191:20-193:3 (testifying that "it was a survey of what channel people were listening to," and that the survey "is not [a reflection of time spent listening to different channels on Sirius] in the sense of not asking people how much time they listen to a particular channel."); *id.* at 196:19-197:3. The survey thus says nothing at all about the time spent listening to each channel. *See id.* at 200:18-205:15 (Dr. Pelcovits explaining that he had to rely on this measurement of number of listeners because he could not find a direct measure of time spent listening). Dr. Pelcovits testified that "I do not have explicit data on how much time people listen to different channels." *Id.* at 207:5-16.

490. Another problem with Dr. Pelcovits' suggestion and the rate proposal SoundExchange has presented in its Option B is that the division between the two tiers and the relative rates applicable to each are admittedly arbitrary. SoundExchange provided no justification or support for separating the top half of the Sirius stations in the listening index nor any support for establishing a 2:1 ratio between the fees applicable to the two tiers. Dr. Pelcovits

acknowledged that "[t]here is a substantial question as to how to allocate listening among the two tiers." Pelcovits WRT at 24 n.40. As Dr. Pelcovits testified about the "illustrative example" he included in his written testimony, the division of the tiers "was arbitrary, just seemed it was where there was a break in the data." 8/28/07 Tr. 210:9:10 (Pelcovits); *cf. id.* at 101:22-102:2 (Pelcovits). Similarly, Dr. Pelcovits applied a 3:1 fee ratio in his example, for which he provided no basis. *See* 8/28/07 Tr. 210:1-5 (Pelcovits) (agreeing that "the three to one relationship of the fee rate between the higher tier and the lower tier was illustrative and not intended to be a recommendation").

491. At any rate, the actual work done by Dr. Pelcovits in his illustrative example was not used to create "Option B" of SoundExchange's Third Amended Rate Proposal. 8/28/07 Tr. 109:2-20 (Pelcovits) (testifying that SoundExchange's Third Amended Rate Proposal "differs in the precise points chosen for establishing the two tiers"). The division of tiers and fee ratio used for Option B were no better grounded than in the illustrative example. Where Neither Dr. Pelcovits nor any other SoundExchange witness has offered any testimony as to the reasoning behind the cutoff point or the calculations, there is no basis for adopting the proposal trusting that they have been calculated fairly or justifiably.

492. Further, Option B also shares the "stepped" structure of Option A, discussed *supra* at Part VI.A., which introduces pernicious incentives and robs the SDARS of all margin between 15 million and as many as 22 million subscribers. Lacking any real support of its own for its Option B proposal, SoundExchange makes up alleged support from Professor Noll's mouth, incorrectly alleging that Professor Noll supported SoundExchange's Option B, see SX PFF ¶ 1459, and that he testified that the SDARS' per-play proposal was "far too distortionary to

use in practice." See SX PFF ¶ 1440. The fact instead is that, although SoundExchange could have asked Professor Noll about its Option B fee proposal, it did not.

493. Professor Noll acknowledged only that the "theoretically correct" way to measure fees would be based on the number of listeners, 8/16/07 Tr. 220:13-21, 221:4-12 (Noll), and that differences in the number of listeners "create the possibility of a distortion," *id.* at 226:15-18. Nowhere in his testimony did Professor Noll say, as claimed by SoundExchange, or even imply, that any "distortionary effect is particularly a concern." SX PFF ¶ 1445. Nor did he ever opine that any distortion of the SDARS' proposal from the "theoretically correct" way would be significant; his bottom line was that the SDARS' proposal was better than a per-play or per-subscriber metric, a fact SoundExchange neglects to mention. *See* 8/16/07 Tr. 227:1-5 (Noll) ("it's less of a distortion to do it that way [the SDARS' per play proposal] than it is to just do it per sub or per revenue."). The only question presented to Professor Noll was whether a per-play fee or a per-listen fee was better, and he opined that would depend on "the costs of actually measuring listening to the distortion costs of adopting an approximation to it." *Id.* at 157:19-22. Further, he made clear that with a per-play fee set at the correct level, any distortion is "not big enough to be worth going through the trouble of the transaction costs" to set a per-listen fee. *Id.* at 220:10-12.

494. Because SoundExchange's Option B is based on arbitrary decisions and calculations, was calculated using Dr. Pelcovits' methodology which relied upon data that did not say what he assumed it to say, and because Dr. Pelcovits himself cannot recommend any specific two-tiered rate structure to the Court, it should be rejected. This option simply provides an idea to the Judges, without a speck of guidance as to how to actually implement the idea fairly

or equitably. The record simply does not contain any testimony or data that would support the structure or figures in Option B.

### E. SoundExchange's Presentation of Option B Confirms that Incidental Performances Should Not Be Subject to Payments in Any Per-Play Fee Set in this Case.

495. The SDARS' Proposed Findings of Fact demonstrate that there is no basis for assessing a fee on non-feature sound recording performances by the SDARS. *See* SDARS PFF ¶¶ 806-08. Indeed, one may scour SoundExchange's Proposed Findings of Fact and Conclusions of Law and see no reference or support for assessing a fee on incidental performances.

496. The lack of basis for charging the SDARS for incidental performances is now expressly confirmed by SoundExchange's defense of its Option B per-play fee.

497. There is no dispute that SoundExchange's Option B was computed by defining compensable plays in exactly the same way as Dr. Woodbury defined them in developing the SDARS' per play fee proposal. SX PFF ¶ 1439; *see* SDARS PFF ¶ 845 n.22; 8/28/07 Tr. 218:13-219:9 (Pelcovits).

498. There similarly is no dispute that Dr. Woodbury counted only feature (non-incidental) performances in determining the number of plays to use in developing the SDARS' fee proposal. SDARS PFF ¶ 845 n.22; SX PFF ¶ 1461; 8/23/07 Tr. 85:17-89:1 (Woodbury); Woodbury WRT ¶ 53; SDARS-Woodbury Ex. 29; SDARS-Woodbury Ex. 30.

499. SoundExchange now concedes that Dr. Woodbury's count was "more precise data on the number of songs subject to the compulsory license that are in fact broadcast by the SDARS each month." SX PFF ¶ 1439. In other words, SoundExchange has embraced Dr. Woodbury's count of "songs subject to the compulsory license. *Id.* (emphasis added)." That count excludes incidental performances.

500. SoundExchange also makes clear that its Options A and B were "each designed to yield the same gross royalty amount if one assumes that the SDARS broadcast the same number of sound recordings subject to the statutory license over the next rate term as they broadcast in the most recent past." *Id.* ¶ 1411; *id.* at ¶ 1436 (The goal of Option B "was to produce a rate that was the same in gross dollar terms as the rates in its Option A."); SoundExchange's Third Amended Fee Proposal at 5 n.1. Because Option B was developed by counting only feature performances, the resulting fee would be far greater than the result in Option A if the per-play fee were assessed against feature and incidental performances. 8/28/07 Tr. 217:7-19 (Pelcovits). Notably, however, SoundExchange does not define "Broadcast" to exclude incidental performances. *See* SoundExchange's Third Amended Rate Proposal at 7 (defining "Broadcast"). Thus, Option B would result in dramatically higher fees than Option A.

### F. SoundExchange's Proposal Regarding the Value of Ephemeral Copies Is an Impermissible Attempt by the Record Labels To Shortchange Performing Artists and Is Not Supported by Any Evidence.

501. Without a shred of evidentiary support, SoundExchange takes the position that 8.8% of the total value of the section 114 and section 112 licenses should be designated as attributable to the license for making ephemeral copies in section 112(e). *See* SX PFF ¶¶ 1513-20. The claimed "basis" for assigning a specific value to the ephemeral reproduction right of section 112 is the fact that "performance royalties are divided 50-50 between record companies and recording artists; royalties from the making of ephemeral copies are paid only to record companies." *Id.* ¶¶ 1518-19. In other words, SoundExchange wants to explicitly attribute a portion of the overall royalties paid by the SDARS to the section 112 license so that its record company members can get a larger piece of the SDARS pie than its performing artist members.

502. SoundExchange does not point to anything in the record of this proceeding to support this proposal or the allegation that the copyright owners and artists it represents accept it.

*See id.* ¶ 1519. Indeed, not a word was said throughout the proceeding by any party about the ephemeral license having any independent value. Certainly this silence supports the position, as the lack of evidence on the topic in *Webcasting II* did, that the section 112 license does not, in fact, have any independent value – if it did, someone would have made that claim out loud. *See Webcasting II* at 24,101. The determination of the value of the ephemeral recording license cannot be based upon facts alleged for the first time in SoundExchange's Proposed Findings of Fact.

503. The Judges should follow the determination in *Webcasting II*, the opinion of the Copyright Office (*see* SDARS PFF ¶ 902), and the unquestionable record of evidence in this proceeding and determine that the section 112 license for the making of ephemeral copies has no value independent of the section 114 performance license.

### G. SoundExchange Has Presented No Evidence Whatsoever in Support of Its Proposed CPI Increases.

504. SoundExchange proposes that the royalty be increased each year in accordance with the percent change in the CPI-U from the previous year. SoundExchange Third Amended Rate Proposal at section 38_.3(a)(2). Not a single witness for SoundExchange mentioned this increase in either their written or oral testimony, or identified the use of such a provision in the benchmark agreements offered as exhibits by SoundExchange. *Cf.* 8/28/07 Tr. 256:3-12 (Pelcovits) (explaining, in response to a question from the bench, that he was not involved in formulating the CPI-increase provision). Nor does it appear that SoundExchange discussed this aspect of their fee proposal anywhere in their Proposed Findings of Fact. A similar provision was rejected by the Judges in Webcasting II because SoundExchange failed to provide any evidence that such provisions exist in the marketplace. *See Webcasting II*, 72 Fed. Reg. at 24,096 ("No evidence has been submitted by SoundExchange to support this additional

adjustment by what is, at this point in time, an indeterminate amount."). For the same reason, this provision of SoundExchange's fee proposal must be rejected here as well.

## VII. THE JUDGES SHOULD ADOPT THE SDARS' PROPOSED TERMS.

505. The terms proposed by SoundExchange and discussed in its Proposed Findings of Fact are largely ones that either (a) the SDARS do not contest or (b) SoundExchange has failed to justify on the record of this proceeding. SoundExchange completely ignores other provisions proposed by the SDARS. The SDARS, by contrast, have presented extensive record evidence in support of their proposed terms, including direct testimony from their witnesses, cross-examination testimony from SoundExchange's Barrie Kessler, and many content agreements. *See, e.g.*, 6/12/07 Tr. 21:15-28:7 (Frear); 6/19/07 Tr. 47:4-115:10 (Kessler); 8/29/07 Tr. 28:11-36:2 (Kessler); SDARS Exs. 85-89; SIR Exs. 43, 52-53. Thus, for the reasons discussed in the SDARS' Proposed Findings of Fact and further below, where the respective terms proposals differ, the Judges should reject SoundExchange's proposals and adopt those of the SDARS.

506. To the extent that the parties appear to agree on specific terms, they do not merit further discussion here.[51] The SDARS have attached as Appendix A a document which reframes and restructures the SDARS' Second Amended Proposed Rates and Terms and incorporates certain terms apparently not in dispute to aid the Judges in comparing the parties' proposals.[52]

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[51] No party has taken a position opposing SoundExchange's request to be named the sole collective for royalty collection and distribution. SoundExchange's positions as to the definition of revenue and the value of the license for ephemeral recordings, which were discussed in its section on terms, are addressed elsewhere in this submission. *See* Part VI.B, E.

[52] References to the SDARS' Second Amended Proposal of Rates and Terms refer to the section numbers in the document filed Oct. 1, 2007, not Appendix A, as Appendix A is not the SDARS' formal terms proposal.

### A. SoundExchange's Late Fee Proposals Impute the Sins of Others onto the SDARS by Relying on Evidence from Another Proceeding that Has No Relevance to the SDARS.

507. SoundExchange attempts to justify its excessive late fee proposal by ignoring mountains of contrary evidence and imputing to the SDARS the sins of other services not covered by the license here at issue. *See* SX PFF ¶¶ 1479-90. SoundExchange likewise engages in selective evidentiary cherry-picking when citing support for its 1.5% per month late fee rate and does not even attempt to justify its proposal that late fees accrue separately on payments, statements of account, and reports of use, which would amount to an exorbitant annual late fee as high as 54%. The Judges should examine the evidence on this record and the payment history of the parties at hand – the SDARS – and adopt SDARS' late fee proposals.

508. The evidence SoundExchange cites in support of its late fee proposal is completely unrelated to the SDARS. For example, SoundExchange's claims that (i) "late payments can range from a few days to a few months," SX PFF ¶ 1483; (ii) "lower late fees . . . fail to give licensees an adequate incentive to timely pay SoundExchange," *id.* at ¶ 1484; and (iii) "[t]he evidence establishes that license[e]s routinely fail to submit timely or accurate reports of use," *id.* at ¶ 1489, all relate to webcasters, not to the SDARS. In fact, the evidence as related to the SDARS shows, in Ms. Kessler's own words, that "XM and Sirius are typically timely with their payments," "typically compliant with regard to their reporting obligations under the agreement," and "typically on time" in submitting required reports. 6/19/07 Tr. 94:14-15, 118:4-7 (Kessler). There is no basis for SoundExchange to suggest that XM and Sirius should be subject to harsh late fees because other licensees are late.

509. Nor is SoundExchange's proposal that the late fee be set at 1.5% per month justified by the evidence in the record of this proceeding. SoundExchange claims that "a late fee of 1.5% is well within the range that parties agree to in the marketplace," SX PFF ¶ 1486, but

once again it relies on evidence from the webcasting proceeding. The agreements in evidence in this proceeding support the SDARS' proposal. Specifically, [[ ]] of the thirteen SDARS content agreements in the record [[ ]], [[ ]] of the agreements and amendments between record labels and digital distribution services [[ ]], and [[ ]] other record label agreements [[ ]]. SDARS PFF ¶ 1312.

510. Against the SDARS' evidentiary demonstration, SoundExchange points only to [[ ]] agreements that [[ ]], and not a single one that has a higher rate. *See* SX PFF ¶ 1487. The evidentiary record thus establishes that a 1.5% late fee is the rare and extreme upper bound of marketplace fees, and the norm is no late fee at all. Accordingly, the SDARS' proposal of 0.5% is far more consistent with the record evidence than SoundExchange's proposal, particularly in light of the SDARS' established record of timeliness.

511. Moreover, SoundExchange is notably silent as to its unprecedented proposal that late fees accrue separately for late payments, statements of account, and reports of use – a provision that would impose upon the SDARS a late fee of as high as 54% per year. *See* SDARS PFF ¶¶ 1316-17. As explained in the SDARS' Proposed Findings of Fact, there is [[ ]], and the evidence directly contradicts the contention that such a provision is necessary to ensure timely submission of reports. *See* SDARS PFF ¶¶ 1319-20. SoundExchange has presented no evidentiary or legal justification for its proposal given this failure of proof, as well as the utter unreasonableness of such a term, the Judges should reject SoundExchange's effort to attach late fees to anything beyond late payments.

### B. SoundExchange's Arguments Regarding Census Reporting Are Either Undisputed or Moot.

512. SoundExchange continues to press its position on census reporting, despite its acknowledgement that the SDARS have proposed census reporting as well, albeit with a few well-supported exceptions. *See* SX PFF ¶¶ 1468-78; *see also* SDARS' Terms Proposal § 3__.6(d).

513. There appears to be no substantial controversy regarding the SDARS' proposal that non-copyrighted, directly licensed, and incidental performances be exempt from reporting requirements. *See* SDARS PFF ¶¶ 1329-32. SoundExchange did not dispute this proposal in its Proposed Findings of Fact, and indeed, it is consistent with the Judges' current notice and recordkeeping regulations. Accordingly, those exceptions should be adopted.

514. SoundExchange also is silent as to the SDARS' proposal that reports submitted in compliance with their recordkeeping obligations covering the SDARS be deemed to satisfy reporting requirements for performances made by the SDARS in other media. *See* SDARS' Terms Proposal § 3__.6(f). The SDARS transmit the same programming on their satellite radio services as they transmit via webcasting and satellite television. If they were subjected to different reporting standards for the same programming in different media, they would face an enormous and inefficient reporting burden and SoundExchange would not have any information in addition to what it would otherwise have. As SoundExchange has not opposed the SDARS' proposal, the Judges should adopt the SDARS' term.

515. SoundExchange disagrees with the SDARS' proposed exemption from reporting for non-music channels, *see* SX PFF ¶¶ 1470-74, but the terms proposal the SDARS submitted with their Proposed Findings of Fact does not include such an exemption. Rather, it exempts only "programming reasonably classified as news, talk or sports." SDARS' Terms Proposal

§ 3__.6(d) (emphasis added). Accordingly, any "long blocs of music programming" on non-music channels would not be exempt from the census reporting requirement, and rendering SoundExchange's argument is moot. *See* SX PFF ¶¶ 1473-74. The SDARS' proposal is a fair and reasonable provision that addresses SoundExchange's concerns. *Cf.* SDARS PFF Part VIII.C.

516. Finally, although SoundExchange criticizes, without discussion, the SDARS' proposal concerning reporting of performances in programming provided by third parties, it mischaracterizes that proposal by suggesting that it would exempt all such programming from any reporting obligation. *See* SX PFF ¶ 1471. In fact, the SDARS merely have proposed a reasonable grandfathering provision well as a provision to include in future contracts language, where commercially feasible, requiring third parties to provide the necessary reporting information. SDARS' Terms Proposal § 3__.6(d)(2). *See also* SDARS PFF ¶¶ 1333-34. This proposal is a fair and reasonable balancing of interests between the copyright owner and the copyright user. *See* 17 U.S.C. § 114(f)(4)(A); *see also* SDARS PFF ¶¶ 1333-34.

### C. SoundExchange Does Not Offer Support for any Disputed Audit Terms, so the SDARS' Audit Terms Should Be Adopted.

517. There does not appear to be any substantial dispute regarding the audit and verification terms that should apply to the licenses at issue.[53] SoundExchange, however, maintains its silence regarding its proposed provision that unreasonably would obligate the SDARS to obtain records from third parties for the purposes of a SoundExchange audit. *See* SDARS PFF ¶¶ 1335-36. SoundExchange has provided no evidence to support this term beyond

[53] In fact, the only such term that SoundExchange specifically mentions is one upon which the SDARS agree: SoundExchange shall pay for the cost of any licensee audits unless at least a 10% underpayment is found. *See* SX PFF ¶¶ 1501-03; SDARS' Second Amended Proposal of Rates and Terms § 3__.4(a)(iv). Therefore, the Judges should adopt that provision.

its claim that the audit provisions here should mirror those adopted in the webcasting proceeding. But the fact that a similar provision exists in the regulations applicable to webcasters is not a sufficient reason to adopt it here, where the evidentiary record is silent on the matter. Accordingly, the term should be rejected, and the audit provisions proposed by the SDARS should be adopted.

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## APPENDIX A

Restatement of SDARS' Second Amended Rates and Terms

PART 3__ -- RATES AND TERMS FOR SUBSCRIPTION TRANSMISSIONS AND THE REPRODUCTION OF EPHEMERAL RECORDINGS BY PREEXISTING SATELLITE DIGITAL AUDIO RADIO SERVICES

Sec.



**§ 3__.1 General.**

(a) Scope. This part 3__ establishes rates and terms of royalty payments for the public performance of sound recordings in certain digital transmissions by Licensees in accordance with the provisions of 17 U.S.C. § 114, and the making of ephemeral recordings by Licensees in accordance with the provisions of 17 U.S.C. §§ 112(e), during the period from January 1, 2007 through December 31, 2012.

(b) Relationship to voluntary agreements. Notwithstanding the royalty rates and terms established in this part, the rates and terms of any license agreements entered into by Copyright Owners and Licensees shall apply in lieu of the rates and terms of this part to transmissions within the scope of such agreements.

**§ 3__.2 Definitions.**

For purposes of this part, the following definitions shall apply:

(a) "Copyright Owner" is a sound recording copyright owner who is entitled to receive royalty payments under 17 U.S.C. § 112(e) or 114(g).

(b) "Collective" is the collection and distribution organization that is designated by the Copyright Royalty Judges. For the 2007-2012 license period, the Collective is SoundExchange, Inc.

(c) "Licensee" is a person that has obtained a statutory license under 17 U.S.C. § 114, and the implementing regulations, to make transmissions over a preexisting satellite digital audio radio service (as defined in 17 U.S.C. § 114(j)(10)), and has obtained a

statutory license under 17 U.S.C. § 112(e) to make ephemeral recordings for use in facilitating such transmission.

(d) "Performers" means the independent administrators identified in 17 U.S.C. § 114(g)(2)(B) and (C) and the parties identified in 17 U.S.C. § 114(G)(2)(D).

(e) "Play" is each instance in which any portion of a sound recording is transmitted by a preexisting satellite digital audio radio service, regardless of the number of listeners who tune in or listen to the transmission, but excluding the following:

(1) A transmission of a sound recording that does not require a license (e.g., a sound recording that is not copyrighted);

(2) A transmission of a sound recording for which the service has previously obtained a public performance license from the copyright owner of such recording; and

(3) An incidental performance that both:

(i) makes no more than incidental use of sound recordings including, but not limited to, brief musical transitions in and out of commercials or program segments, brief performances during news, talk and sports programming, brief background performances during disk jockey announcements, brief performances during commercials of sixty seconds or less in duration, or brief performances during sporting or public events; and

(ii) other than ambient music that is background at a public event, does not contain an entire sound recording and does not feature a particular sound recording of more than thirty seconds (as in the case of sound recording used as a theme song).

(f) "Qualified Auditor" is a Certified Public Accountant.

(g) "SDARS" means the preexisting satellite digital audio radio services as defined in 17 U.S.C. § 114(j)(10).

(h) "Term" means the period commencing January 1, 2007, and continuing through December 31, 2012.

**§ 3__.3 Royalty fees for public performances of sound recordings and the making of ephemeral recordings.**

Commencing January 1, 2007 and continuing through December 31, 2007, the royalty fee to be paid by a Licensee for the public performance of sound recordings pursuant to 17 U.S.C. § 114(d)(2) and the making of any number of ephemeral phonorecords to facilitate such performances pursuant to 17 U.S.C. § 112(e) shall be $1.60 per Play of a copyrighted sound recording. The royalty rate to be paid for Plays in 2008 and

subsequent years of the license period shall be adjusted each year by a percentage equal to the percentage change in combined SDARS subscribers during the preceding year. (For example, if the number of subscribers to both SDARS at the end of 2007 has increased twenty percent from year-end 2006, the royalty fee for 2008 will increase by twenty percent, to $1.92 per Play.)

**§ 3__.4 Terms for making payment of royalty fees and statements of account.**

(a) Payment to the Collective. A Licensee shall make the royalty payments due under § 3__.3 to the Collective.

(b) Designation of the Collective.

(1) Until such time as a new designation is made, SoundExchange, Inc., is designated as the Collective to receive statements of account and royalty payments from Licensees due under § 3__.3 and to distribute such royalty payments to each Copyright Owner and Performer, or their designated agents, entitled to receive royalties under 17 U.S.C. § 112(e) or § 114(g).

(2) If SoundExchange, Inc. should dissolve or cease to be governed by a board consisting of equal numbers of representatives of Copyright Owners and Performers, then it shall be replaced by a successor Collective upon the fulfillment of the requirements set forth in paragraph (b)(2)(i) of this section.

(i) By a majority vote of the nine Copyright Owner representatives and the nine Performer representatives on the SoundExchange board as of the last day preceding the condition precedent in paragraph (b)(2) of this section, such representatives shall file a petition with the Copyright Royalty Judges designating a successor to collect and distribute royalty payments to Copyright Owners and Performers entitled to receive royalties under 17 U.S.C. § 112(e) or § 114 that have themselves authorized such Collective.

(ii) The Copyright Royalty Judges shall publish in the Federal Register within 30 days of receipt of a petition filed under paragraph (b)(2)(i) of this section an order designating the Collective named in such petition.

(c) Quarterly Payments. A Licensee shall make any payments due under § 3__.3 by the 60th day after the close of each calendar quarter for all Plays during that calendar quarter. In the event the deadline for any payment due under this part falls on a day which is not a business day, payment shall be due on the next business day. All payments shall be rounded to the nearest cent.

(d) Late Fee. If a Licensee fails to make any payment under this part when due and following ten days after receipt of written notice from the Collective, the Licensee shall pay a late fee on any overdue amount of 0.50% per month, or the highest lawful rate, whichever is lower, from the date of receipt of written notice until the date full payment

is received by the Collective.

(e) Statements of Account. Licensees shall submit quarterly statements of account on a form provided by the agent designated to collect such forms and the royalty payments. A statement of account shall include only such information as is necessary to calculate the accompanying royalty payment and the name, address, telephone number, and electronic mail address of the person to be contacted for information or questions concerning the content of the statement of account.

(f) Distribution of royalties. The Collective shall promptly distribute royalties received from Licensees to Copyright Owners and Performers, or their designated agents, that are entitled to such royalties. The Collective shall only be responsible for making distributions to those Copyright Owners, Performers, or their designated agents who provide the Collective with such information as is necessary to identify the correct recipient. The Collective shall distribute royalties on a basis that values all performances by a Licensee equally based upon the information provided under the reports of use requirements for Licensees contained in § 3__.8 of this chapter.

(g) Retention of records. Books and records of a Licensee and of the collective relating to payment of and distributions of royalties shall be kept for a period of not less than the prior 3 calendar years after submission of the statement of account.

**§ 3__.5 Confidential information.**

(a) Definition. For purposes of this part, "Confidential Information" shall include the statements of account and any information contained therein, including the amount of royalty payments, and any information pertaining to the statements of account designated as confidential by the Licensee filing the statement. Confidential information shall also include any information so designated in a confidentiality agreement which has been duly executed between a Licensee and an interested party, or between one or more interested parties; Provided that all such information shall be made available, for the verification proceedings provided for in § 3__.6 of this part.

(b) Exclusion. Confidential Information shall not include documents or information that at the time of delivery to the Collective are public knowledge. The party claiming the benefit of this provision shall have the burden of proving that the disclosed information was public knowledge.

(c) Use of Confidential Information. In no event shall the Collective use any Confidential Information for any purpose other than royalty collection and distribution and activities related directly thereto.

(d) Disclosure of Confidential Information. Access to Confidential Information shall be limited to:

(i) Those employees, agents, attorneys, consultants and independent contractors of the Collective, subject to an appropriate confidentiality agreement, who are engaged in the collection and distribution of royalty payments hereunder and activities directly related hereto, who are not also employees or officers of a sound recording copyright owner or performing artist, and who, for the purpose of performing such duties during the ordinary course of employment, require access to the Confidential Information;

(ii) An independent and Qualified Auditor, subject to an appropriate confidentiality agreement, who is not an employee or officer of a sound recording copyright owner or performing artist, but is authorized to act on behalf of the Collective with respect to verification of a Licensee's statement of account pursuant to § 3__.6 or on behalf of a Copyright Owner or Performer with respect to the verification of royalty distributions pursuant to § 3__.7;

(iii) In connection with future proceedings under 17 U.S.C. § 112(e) and § 114(f) before the Copyright Royalty Judges, and under an appropriate protective order, attorneys, consultants and other authorized agents of the parties to the proceedings or the courts, who are not employees or officers of a sound recording copyright owner or performing artist.

(e) Safeguarding of Confidential Information. The Collective and any person identified in paragraph (d) of this section shall implement procedures to safeguard against unauthorized access to or dissemination of any Confidential Information using a reasonable standard of care, but no less than the same degree of security used to protect Condfidential Information or similarly sensitive information belonging to the Collective or person.

**§ 3__.6 Verification of Royalty Payments.**

(a) General. This section prescribes procedures by which a Collective may verify the royalty payments made by a Licensee. If there is more than one Collective, all Collectives shall mutually retain a single auditor to perform a single audit on a Licensee.

(b) Frequency of verification. The Collective may conduct a single audit of a Licensee, during reasonable business hours at a mutually agreeable time, during any given calendar year, for any or all of the 36 months prior to the commencement of the audit, but no calendar year shall be subject to audit more than once. An audit shall commence no later than 90 days following a written request for audit.

(c) Notice of intent to audit. The Collective must file with the Copyright Royalty Judges a notice of intent to audit a particular Licensee, which shall, within 30 days of the filing of the notice, publish in the Federal Register a notice announcing such filing. The notification of intent to audit shall be served at the same time on the Licensee to be audited. Any such audit shall be conducted by an independent and Qualified Auditor according to generally accepted auditing standards.

(d) Acceptable verification procedure. An audit, including underlying paperwork, which was performed in the ordinary course of business according to generally accepted auditing standards by an independent and Qualified Auditor, shall serve as an acceptable verification procedure for all parties with respect to the information that is within the scope of the audit. The Collective shall retain the report of the verification for a period of not less than 3 years.

(e) Consultation. Before rendering a written report to the Collective, except where the auditor has a reasonable basis to suspect fraud and disclosure would, in the reasonable opinion of the auditor, prejudice the investigation of such suspected fraud, the auditor shall review the tentative written findings of the audit with the appropriate agent or employee of the Licensee being audited in order to remedy any factual errors and clarify any issues relating to the audit; Provided that an appropriate agent or employee of the Licensee reasonably cooperates with the auditor to remedy promptly any factual errors or clarify any issues raised by the audit.

(f) Costs of the verification procedure. The Collective shall pay the cost of the verification procedure unless it is finally determined that there was an underpayment of 10% or more, in which case the Licensee shall, in addition to paying the amount of any underpayment, bear the reasonable costs of the verification procedure.

(h) Overpayment. If as a result of the audit the auditor determines that a Licensee has overpaid royalties, the Licensee may credit against future royalty payments the amount of such overpayment plus interest accrued at the rate provided in 28 U.S.C. § 1961, and shall pay the Licensee's reasonable out-of-pocket costs incurred from the audit.

**§ 3__.7 Verification of royalty distributions.**

(a) General. This section prescribes procedures by which any Copyright Owner or Performer may verify the royalty distributions made by a Collective; provided, however, that nothing contained in this section shall apply to situations where a Copyright Owner or Performer and the Collective have agreed as to proper verification methods.

(b) Frequency of verification. A Copyright Owner or Performer may conduct a single audit of a Collective upon reasonable notice and during reasonable business hours, during any given calendar year, for any or all of the prior 3 calendar years, but no calendar year shall be subject to audit more than once.

(c) Notice of intent to audit. A Copyright Owner or Performer must file with the Copyright Royalty Judges a notice of intent to audit a Collective, which shall, within 30 days of the filing of the notice, publish in the Federal Register a notice announcing such filing. The notification of intent to audit shall be served at the same time on the Collective. Any audit shall be conducted by an independent and Qualified Auditor identified in the notice, and shall be binding on all Copyright Owners and Performers.

(d) Acquisition and retention of report. The Collective shall use commercially reasonable efforts to obtain or to provide access to any relevant books and records maintained by third parties for the purpose of the audit. The Copyright Owner or Performer requesting the verification procedure shall retain the report of the verification for a period of not less than 3 years.

(e) Acceptable verification procedure. An audit, including underlying paperwork, which was performed in the ordinary course of business according to generally accepted auditing standards by an independent and Qualified Auditor, shall serve as an acceptable verification procedure for all parties with respect to the information that is within the scope of the audit.

(f) Consultation. Before rendering a written report to a Copyright Owner or Performer, except where the auditor has a reasonable basis to suspect fraud and disclosure would, in the reasonable opinion of the auditor, prejudice the investigation of such suspected fraud, the auditor shall review the tentative written findings of the audit with the appropriate agent or employee of the Collective in order to remedy any factual errors and clarify any issues relating to the audit; Provided that the appropriate agent or employee of the Collective reasonably cooperates with the auditor to remedy promptly any factual errors or clarify any issues raised by the audit.

(g) Costs of the verification procedure. The Copyright Owner or Performer requesting the verification procedure shall pay the cost of the procedure, unless it is finally determined that there was an underpayment of 10% or more, in which case the Collective shall, in addition to paying the amount of any underpayment, bear the reasonable costs of the verification procedure.

**§ 3__.8 Notice and Recordkeeping.**

(a) General. This section prescribes the rules under which Licensees shall serve copyright owners with notice of use of their sound recordings, what the content of that notice should be, and under which records of such use shall be kept and made available.

(b) Definition. A *"Report of Use of Sound Recordings Under Statutory License"* (sometimes referred to as a *"Report of Use"*) is the sole report of use required to be provided by a Licensee under this Agreement.

(c) Service. Reports of Use shall be served upon SoundExchange. Licensees shall serve Reports of Use on SoundExchange by no later than the ninetieth day after the close of each month. Reports of Use shall be served, by certified or registered mail, or by other means provided in SoundExchange's "File and Reports of Use Delivery Specifications" filed in the Copyright Office in Docket No. RM 2002-1B or agreed upon by a Licensee and SoundExchange.

(d) Content.

(1) A "Report of Use of Sound Recordings under Statutory License" shall be identified as such by prominent caption or heading, and shall include a Licensee's intended or actual playlist for each channel and each day of the reported month, except that no reporting requirement shall apply to programming reasonably classified as news, talk or sports. Subject to subsection (d)(2), each intended or actual playlist shall include a consecutive listing of every recording scheduled to be or actually transmitted, as the case may be, and shall contain the following information in the following order:

(A) The name of the service or entity;

(B) The channel;

(C) The sound recording title;

(D) The featured recording artist, group, or orchestra;

(E) The retail album title;

(F) The marketing label of the commercially released and available album or other product on which the sound recording is found;

(G) The catalog number for albums or other products commercially released;

(H) The International Standard Recording Code (ISRC) embedded in the sound recording, where available and feasible, for albums or other products commercially released after 1998;

(I) Where available, the copyright owner information provided in the copyright notice on the retail album or other product (e.g., following the symbol ℗ (the letter P in a circle) or, in the case of compilation albums created for commercial purposes, in the copyright notice for the individual sound recording, for commercially released albums or other products;

(J) The date of transmission;

(K) The time of transmission; and

(L) The release year of the retail album or other product (as opposed to the individual sound recording), as provided in the copyright notice on the retail album or other product (e.g., following the symbol © (the letter C in a circle), if present, or otherwise following the symbol ℗ (the letter P in a circle)), for commercially released albums or other products.

(2) Notwithstanding subsection (d)(1) –

(A) In the case of programming provided to a Licensee by a third party programmer –

(i) if such programming is provided to the Licensee under a contract entered into before the effective date and not thereafter amended or renewed, then the Licensee shall have no obligation to provide Reports of Use with respect to that programming; and

(ii) the Licensee shall use commercially reasonable efforts to include in any new contract for programming, or any amendment or renewal of such a contract, a requirement that the provider of programming provide the Licensee the information required by subsection (d)(1), or in the case of programming consisting of simultaneous retransmission of an over-the-air terrestrial AM or FM radio broadcast by a broadcaster that also transmits such programming over the Internet, such information as may from time to time be required by Copyright Office regulations relating to the broadcaster's transmissions over the Internet, and the Licensee shall provide SoundExchange Reports of Use containing the information provided by the third party programmer.

In any case in which a Licensee does not provide Reports of Use for programming provided to a Licensee by a third party programmer, the Licensee shall report to SoundExchange the relevant channel and the reason it is unable to provide such Reports of Use.

(B) Licensees only shall be required to provide the information identified in subsections (d)(1)(C) through (F) to the extent that such information can be provided using commercially reasonable efforts.

(C) Licensees shall not be required to provide information with respect to a performance of a sound recording that does not require a license (*e.g.*, the sound recording is not copyrighted)

(D) Licensees shall not be required to provide information with respect to a performance of a sound recording for which the service has previously obtained a license from the Copyright Owner of such sound recording; and

(E) Licensees shall not be required to provide information with respect to an incidental performance that both: (i) makes no more than incidental use of sound recordings including, but not limited to, brief musical transitions in and out of commercials or program segments, brief performances during news, talk and sports programming, brief background performances during disk jockey announcements, brief performances during commercials of sixty seconds or less in duration, or brief

performances during sporting or other public events, and (ii) other than ambient music that is background at a public event, does not contain an entire sound recording and does not feature a particular sound recording of more than thirty seconds (as in the case of a sound recording used as a theme song).

(e) Signature. Reports of Use shall include a signed statement by the appropriate officer or representative of the Licensee attesting that the information contained in the Report is believed to be accurate and is maintained by the Licensee in its ordinary course of business. The signature shall be accompanied by the printed or typewritten name and title of the person signing the Report, and by the date of signature.

(f) Other Media. If a Licensee makes digital audio transmissions of sound recordings in any medium other than through its SDARS, reports containing the elements set forth in subsection (d) shall be deemed to satisfy the Licensee's obligations to identify the sound recordings used in such transmissions (in contrast to any obligations the Licensee may have under applicable regulations to provide information concerning matters other than the identity of such sound recordings).

(g) Format. Reports of Use shall be provided in accordance with SoundExchange's "File and Reports of Use Delivery Specifications" filed in the Copyright Office in Docket No. RM 2002-1B.

(h) Confidentiality.

(1) Definition. "Confidential Information" means information submitted by a Licensee to SoundExchange in a Report of Use that is uniquely specific to Licensee, including without limitation, the number of performances made by the Licensee and the identification of particular sound recordings as having been performed by the Licensee, but not any information that at the time of delivery to Sound Exchange is generally known to the public or subsequently becomes generally known to the public through no fault of SoundExchange, including without limitation, information identifying sound recordings themselves.

(2) Use of Confidential Information. SoundExchange shall not use any Confidential Information for any purpose other than royalty collection and distribution, determining and enforcing compliance with statutory license requirements and the requirements of this Agreement, and activities directly related to the foregoing; provided that SoundExchange may report Confidential Information to its members in a form in which information pertaining to both Licensees is aggregated with information pertaining to other statutory licensees such that Confidential Information pertaining to Licensees, either individually or collectively, cannot readily be identified.

(3) Disclosure of Confidential Information. Access to Confidential Information shall be limited to those employees, agents, attorneys, consultants

and independent contractors of SoundExchange, subject to an appropriate confidentiality agreement, who are not also employees or officers of a Copyright Owner or Performer, and who, for the purpose of performing such duties during the ordinary course of their work, require access to Confidential Information. SoundExchange also may disclose Confidential Information to a successor or assignee permitted by this Agreement.

(i) Documentation. Licensees shall, for a period of at least three years from the date of service of the Report of Use, keep and retain a copy of the Report of Use.

## CERTIFICATE OF SERVICE

I hereby certify that the foregoing Public Version of Reply to SoundExchange's Proposed Findings of Fact, Jointly Submitted by Sirius Satellite Radio Inc. and XM Satellite Radio Inc. was served on October 16, 2007 via overnight mail on the following party:

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